Chapter - 1

Basics of Financial Accounting

Sr. No	Course outline – Topics
1	Definition of Accounting and financial information
2	Sources of Financial Information
3	Money Measurement Concept and Financial Position
4	Functions of Financial Accounting
5	Elements of Financial Statements
6	Entity and Separate Entity Concept
7	User of Financial Information
8	Underlying Assumption – Going Concern
9	Recognition of the elements of financial statements
10	Measurement of the elements of financial statements
11	Qualitative characteristics of useful financial information

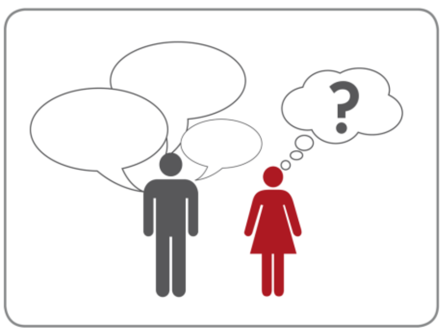
Topic Videos 001-011 are mandatory part of this module

Definition of Accounting

<u>Accounting</u> is a <u>language</u> that is used to communicate and understand the financial ideas, financial expressions, financial thoughts and <u>financial information</u>.

Language

Language is a medium that is used to **communicate** and **understand** some ideas, feelings, expressions or information.



Financial information

Any information that is measurable in terms of money and causes a **change in financial position** of an entity is known as financial information.

Sources of Financial Information

There are three sources of financial information, which are also known as accounting phenomena.

i) Transactions

Transactions are the outcome of dealings made.

ii) Events

Events are the outcome of incidents happened.

iii) Conditions

Conditions are the adjustments in recorded information.

Transaction (source of financial information)
Transaction occurs when two persons deal with each other.

Social motives dealings ⇨ Social transaction
For example; a person receiving birthday gift from his friend is a social transaction.

Economic benefits dealing ⇨ Accounting transaction
Accounting transaction is a monetary dealing between the entity (business / non business) and other person. An accounting transaction causes **change in <u>financial position</u>** (financial status) of the entity.

Dealing between entity and other person includes:

1. Dealing of entity (first party) with owner/s (Second party)

2. Dealing of entity (first party) with any person other than the owner/s (third parties).

From this details we can extract two *criteria* to identify accounting transaction:

1. Measurability in terms of money, and
2. Dealing of the entity with other person.

Practice 1.1

Keeping in view the criteria, identify which of the following information is accounting transaction:

1. Payment of staff salaries made by cheque.
2. Appointing a production manager on contract.
3. Having a conversation with foreign supplier for import of raw material.
4. Placing an order for purchase of production machine.
5. Purchasing motor vehicle and paying cash for the price.

Answer: (1, 5)

Explanation;

1. This is a dealing between **entity** and **employee** that is measurable in money.
2. Activity has no effect on financial position – there is no money measurement.
3. Activity has no effect on financial position – there is no money measurement.
4. Activity has no effect on financial position – there is no money measurement.
5. This is a dealing between **entity** and **car showroom** that is measurable in money.

Practice 1.2

Identify accounting transactions:

1. Up-keeping expenses of building paid by cheque.
2. Collection of dues from customers.
3. Negotiating with bank for taking loan.
4. Receiving cash against loan from bank.
5. Payment of personal expenses of the owner in cash.

Answer: (1, 2, 4, 5)

Explanation:

1. This is a dealing between **entity** and **repairer** that is measurable in money.
2. This is a dealing between **entity** and **customer** that is measurable in money.
3. Activity has no effect on financial position – there is no money measurement.
4. This is a dealing between **entity** and **bank** that is measurable in money
5. This is a dealing between **entity** and **owner** that is measurable in money

Event (source of financial information)
Event means anything that happens. There are two types of events, **Monetary** and **Non-Monetary** events.

Monetary Event
It is an outcome of happening or occurrence of incident that can be measured in terms of money and can cause a change in financial position (financial status) of an entity.

Examples include:
Loss by fire.

Loss by accident.

Foreign exchange (gain/loss)

Non-Monetary Event
It is an outcome of happening or occurrence of incident that cannot be measured in terms of money and cannot cause a change in financial position (status) of an entity.

Examples include:
Winning or losing a game that does not carry financial impacts

Condition (source of financial information)
Condition is the third source of financial information. It requires certain adjustments to be made in already recorded transactions and events.

Examples include:

- **Fixed Assets to be depreciated according to their expected useful life**
- **Provision to be created against expected doubtful recovery from customer**

Practice 1.3

Which of the the following information is Transaction, Event or Condition.

1. Stock in godown lost by fire
2. Giving away gifts to employees of the entity
3. Training to employees through external trainers
4. Organizing a dinner for entity's valued customers
5. Recognizing depreciation of machinery
6. Insurance claim recovered from insurance company against stock lost by fire
7. Cash paid as charity to a hospital

Answer: 1. Event – 2. Transaction – 3. Transaction – 4. Transaction – 5. Condition – 6. Transaction – 7. Transaction
Explanation:

1. Fire accident is **not a dealing** between two persons, value of loss of stock due to fire is an outcome of fire accident that is measurable in terms of money. Therefore it is an event.
2. It's a dealing between **entity** and **employees** and also measurable in terms of money. Therefore, it is a transaction.
3. It's a monetary dealing between **entity** and **external trainers**. Therefore, it is transaction
4. It's a dealing between **entity** and **restaurant** that is measurable in terms of money. Therefore, it is a transaction.
5. It is an adjustment in the value of already purchased machinery in order to show money measurement of the benefits obtained from that machinery during the reporting period. Therefore, it is termed as condition.
6. It's a dealing between **entity** and **insurance company**. It is measurable in terms of money. Therefore, it is a transaction.
7. It's a dealing between **entity** and **charitable institute**. It is measurable in terms of money. Therefore, it is a transaction.

Money measurement

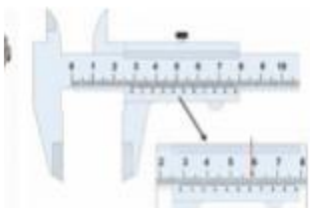
Money measurement is often misunderstood as receipt or payment of cash. Whereas, money measurement means to assign a value in reporting currency to the information, regardless the cash is still payable or receivable.

To better understand the concept of money measurement let us understand the idea of other measurements.

In order to measure a table; different parameters may be used for its measurement such as:

Measuring its weight	10.0 Kg
Measuring its length	3.0 Feet
Measuring its width	1.5 Feet
Measuring its height	2.0 Feet

Whereas, money value assigned to this table, Rs. 15,000 will be its *money measurement*.




Practice 1.4

Which of the following information is carrying money measurement?

1. Bought 30 numbers of computers.
2. Bought 10 fans @ Rs. 1,500 each, cash paid immediately.
3. Scrap dumped, weighted 150 Kg.
4. 5 workers are working on the plant in double shift.
5. Bought raw material worth Rs. 50,000, cash is not yet paid.

Answers: (2 & 5)

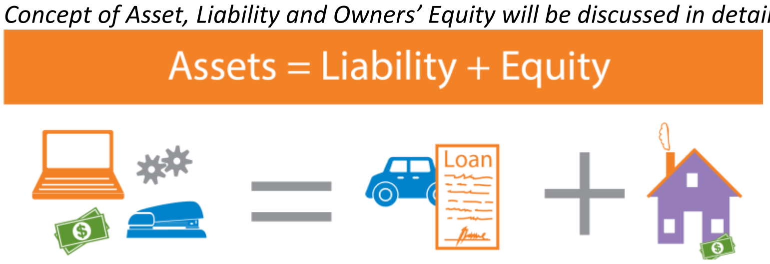
Explanation:

1. Only quantity is given, no currency value is known.
2. Quantity and currency value are given. Money value is measurable (10 fans x Rs.1,500 = Rs. 15,000)
3. Only quantity is given, no currency value is known.
4. Only quantity is given, no currency value is known.
5. Money value of raw material is available in the information.

Financial position

Financial position means; an entity's status of Resources & Sources. **Resources** are the assets that an entity holds in its control and **Sources** are the means of finances through which the entity makes such assets. Means of finances include; liability and owners' equity.

Concept of Asset, Liability and Owners' Equity will be discussed in detail in the upcoming topics.



ASSETS	Rs.	LIABILITIES	Rs.
Furniture	80,000	Bank loan	35,000
Computers	10,000	Other payable	15,000
		EQUITY	
		Owner's Capital	40,000
TOTAL	**90,000**	**TOTAL**	**90,000**

Functions of financial accounting (Accounting cycle)

Financial accounting is a subject that is about financial information. It is said that where-ever there is financial information; there would be a need of financial accounting.

Financial accounting is used to:

1. Classify,
2. Record,
3. Summarize,
4. Report, and
5. Analyze

the financial information of an entity by using different accounting tools.

So, there are five functions of Financial Accounting.

1. **Classifying**. All types of financial information are classified into five main heads:
    i. Assets
    ii. Liabilities
    iii. Incomes
    iv. Expenses
    v. Owners Equity.

These **main heads** are further sub-classified into **accounting heads**, which are then used for recording accounting transactions in the books of accounts.

Main Heads	Assets	Expenses	Owners' Equity	Liabilities	Incomes
Accounting Heads	Land	Purchases	Capital	Bank loan	Sales
	Building	Salaries	Drawings	Bank overdraft	ServiceFee
	Machinery	Electricity	Profits	Creditors	Commission
	Furniture	Repair	etc.	Payable	etc.
	Motor Van	Advertisement		etc.	
	Computer	Telephone			
	Stocks	Traveling			
	Receivables	Freight			
	Cash Balance	Rent			
	Bank Balance	Stationery			
	etc.	etc.			

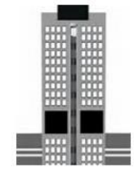
2. **Recording**. Financial information are recorded in the books of accounts according to the prescribed rules
3. **Summarizing**. Recorded financial information is summarized in another book of account. These summaries are prepared for each accounting head that are named as ledger accounts
4. **Reporting**. The results of summaries of each accounting head are reported to the users of financial information by preparing financial statements
5. **Analyzing**. Finally the facts reported are analyzed for certain decision making purposes

Elements of Financial Statements

All financial information of a business entity are divided into five main heads of accounts. These are also known as elements of financial statements, according to the conceptual framework of financial reporting by IFRS.

Assets:

Assets are the resources in control of entity as a result of past event for which there is a probability that there will be an inflow of economic benefits to the entity in future.



Liabilities:

Liabilities are the present obligations of entity arising from past events for which there is a probability that there will be outflow of resources embodying economic benefits for the entity in future.

Income:

Incomes are earnings of the entity through **Revenue** or **Gains**. Income simultaneously causes increase in economic benefits during the reporting period in the form of inflows or enhancements of assets or decrease of liabilities that result in increase in equity, other than those relating to contributions from equity participants.
Sources of revenue are; sales of goods or services and return on investments.
Sources of gains are; profit on disposal of assets and discounts on settlement of liabilities.

Expense:

Expenses are the costs that expire during the reporting period of entity. Expenses simultaneously cause decrease in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity, other than those relating to distributions to equity participants.
These must match with current year's revenue. It includes **losses** sustained during the reporting period.

Owners' Equity:

Owners' equity is the source of finance that represents owners' stake in the entity. Equity is the residual interest in the assets of the entity after deducting all its liabilities.
Components of owners' equity are; introduction of resources by owner into the business (capital); profits generated by the entity (net profit); distributions of profits to the owners for personal use (drawings/dividends).

Entity

It is an activity that is undertaken by individuals or group of people for some **purpose** (profit or non profit)**.**

Purpose

Profit motive

↓

Business

It is an economic activity, which is undertaken to earn profits. It is initially financed by owners and all of its risks and rewards also belong to its owners.

Non profit motive

↓

Welfare Society

It is a welfare organization, which is undertaken by some volunteers and its motive is to help the other beings.

Financial information is involved in both profit motive and non profit motive entities. Therefore, financial accounting is a need for a business as well as a welfare society.

Profit motive

Non-profit motive

Separate Entity Concept

A business entity and its owner are two different persons. For accounting purposes, business has separate entity/identity apart from its owner.

As a student of accounting, while analysing the transactions, you must focus on the accounting information considering yourself as an accountant of the business for which you are analysing the transactions. Do not consider yourself as an owner of that business.

Owner's personal expenses like food, medicines, clothing, house rent etc., which are paid by the owner from his/her owned resources are not financial information belonging to the business unless those are paid from business cash resources on behalf of the owner.

Practice 1.5

Based on the business entity concept, which of the following information would be accounted for in the accounting books of an entity/business?

1. Cash invested as capital of the business by the owner.
2. Owner bought motor car for his personal use out of his personal bank account.
3. Owner used a part of his residential building for the business godown for which he was paid rent out of business bank account.
4. Owner took loan for his daughters' marriage from a friend.
5. Goods bought by business for trading were consumed by the owner for his personal consumption.

Answers (1, 3, 5)
Explanation:

1. It will affect cash asset and owner equity of the business.
2. There will be no effect of this transaction on business.
3. It will affect the business bank account.
4. There will be no effect of this transaction on business.
5. This transaction will decrease the stock balance of the business.

Users of Financial Information

According to the Conceptual Framework for Financial Reporting, "The objective of financial statements is to provide information about the financial position, financial performance and changes in financial position of an entity that is useful to a wide range of users in making accounting decisions."

A business must report its financial information because there are various groups of people who want or need to know it. Following groups are likely to be interested in financial information of an entity.

(a) Investor/Shareholders/owners

To assess how well the management is performing. How profitable are the operations? How much profit they can easily withdraw from the business for their own use.

(b) Trade contacts

Suppliers and customers are two main trade contacts. Suppliers want to know about the entity's ability to pay its debts against supplies on credit terms, customers need to know that the entity is a secured source of supply and is in no danger of having to close down.

(c) Lenders

Providers of finance are lenders to entity might include a bank. The bank wants to ensure that the entity is able to keep up interest payments, and eventually to repay the amounts advanced.

(d) Taxation authorities

Interested to know about profits in order to assess the tax payable by the entity, including sales taxes etc.

(e) Manager and Employees

Need information about the entity's financial situation, because their future careers and the size of their wages and salaries depend on it. To enable them to manage the business efficiently and to make effective decisions

(f) Financial consultants and advisers

Need information for their clients or audience.

For example, stockbrokers need information to advise investors, credit agencies want information to advise potential suppliers of goods to the concern; and journalists need information for their reading public.

(g) Government

Interested in the allocation of resources. They also require information in order to provide a basis for national statistics.

(h) Public

Entity affects members of the public in a variety of ways. For example, entity may make a substantial contribution to a local economy by providing employment and using local suppliers. Another important factor is the effect of an entity on environment, for example, as regards pollution.

Practice 1.6

State following statements are true or false:

1. Debt burden of the company is the information mostly require by income tax authorities.
2. Dividend declaration is the information needed by shareholders.
3. Financial ratios are most likely require by financial consultants
4. Bonus to employee's is the information that is needed by Government.
5. Cost of sales information is usable for managers.
6. Welfare society is always interested in green policies cost of company.

Answers: (1-false 2-true 3-true 4-False 5-true 6-True)
Explanation:

1. This information is required by lenders, investors and shareholders
2. True
3. True
4. Such information is required by income tax authorities and managers
5. True
6. True

Underlying Assumption

Going concern

Assumption that a business unit will remain in existence for the foreseeable future
The IFRS Conceptual Framework states that the going concern assumption is an underlying assumption, it is assumed that the entity will realize its assets and settle its obligations in the normal course of the business. Thus, the financial statements presume that an entity will continue in operation indefinitely or, if that presumption is not valid, disclosure and a different basis of reporting are required.

Examples include:

- Significant trading losses being incurred for several years. Profitability of a company is essential for its survival in the long term.
- Deteriorating liquidity position of a company not backed by sufficient financing arrangements.
- High financial risk arising from increased debts level causing the company to delays in payment of interest and loan.
- Aggressive growth strategy not backed by sufficient finance which ultimately leads to over trading.
- Increasing level of short term borrowing and overdraft not supported by increase in business.
- Serious litigations faced by a company which does not have the financial strength to pay the possible settlement.
- Inability of a company to develop a new range of commercially successful products.
- Bankruptcy of a major customer of the company.

Recognition of the elements of financial statements

Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the following criteria for recognition:

- It is probable that any future economic benefit associated with the item will flow to or from the entity; and
- The item's cost or value can be measured with reliability.

Based on these general criteria:

- **An asset** is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.
- **A liability** is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.
- **Income** is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).
- **Expenses** are recognised when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).

Measurement of the elements of financial statements

Measurement involves assigning monetary amounts at which the elements of the financial statements are to be recognised and reported.

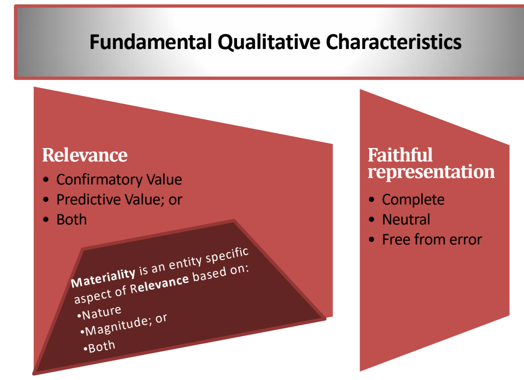
The IFRS Framework acknowledges that a variety of measurement bases are used today to different degrees and in varying combinations in financial statements, including:

- Historical cost
- Current cost
- Fair Value (reallizable value / settlement value)
- Present value (discounted cash flows)

Historical cost is the measurement basis most commonly used today, but it is usually combined with other measurement bases. The IFRS Framework does not include concepts or principles for selecting which measurement basis should be used for particular elements of financial statements or in particular circumstances. However, individual standards and interpretations do provide this guidance.

Qualitative characteristics of useful financial information

Fundamental qualitative characteristics



Relevance

Relevance refers to whether the information makes a difference to the decision maker in order to make *predictions* about the outcome of past, present and future events or to *confirm* and correct prior expectations, e.g., report of bank balance that is essential to determine how much to borrow.

To be relevant, information must have confirmatory value, predictive value or both.

Confirmatory value is the exchange value, i.e., the value of one thing in terms of another at any place or time, e.g., the expected selling price of a non-current asset less costs to sell.

Predictive value is the ability of accounting numbers to provide information that is useful in predicting future accounting numbers, e.g., present value of expected future cash flows (known as value in use).

The confirmatory value and predictive value of financial information are interrelated. Information that has predictive value often also has confirmatory value.

Materiality *(entity specific aspect of relevance)*

Materiality is the basis for recognizing a transaction in the financial reporting process. It is the extent to which financial information is material. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.

Therefore, information is considered material if its omission could influence the decision making of the users.

Faithful representation

Faithful representation is the correspondence between accounting figures and descriptions and the resources or events that these figures and descriptions represent. Information must faithfully represent the effects of transactions and other events.

To be a perfectly faithful representation, a depiction would have the following three characteristics:

● *Complete* A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

● *Neutral* A neutral depiction is without bias in the selection or presentation of financial information, which does not mean information with no purpose or no influence on behavior.

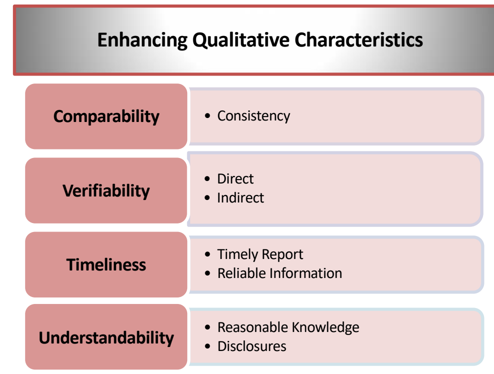
● *Free from error* It means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process.

A faithful representation, by itself does not necessarily result in useful information, e.g., reporting an asset acquired through a government grant at nominal value.

Example – Getting prepared for facing loss because of doubtful recovery from customers (economic phenomena)

The information about this economic phenomenon should be useful (relevant & faithful) (comparable, verifiable, timely & understandable)

Enhancing qualitative characteristics



The qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented are:

Comparability

It requires consistent accounting treatments of items in the financial statements of different entities at the same point of time so as to enable valid comparison. Two sets of financial statements would have comparability if they had been prepared on the same basis and include similar type of value.

Verifiability

It means that the measurement made by one measurer will be confirmed by another. It exists when there is a high degree of consensus among independent measurers, i.e., independent accountants using the same measurement process arrived substantially at same results. Verification can be:

- *direct* (verifying an amount or other representation through direct observation; (e.g., by counting cash); or
- *indirect* (checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology, (e.g., using FIFO method)

Timeliness

It is necessary to balance the relative merits of timely reporting, and the provision of reliable information. If reporting is delayed until all aspects are known, the information may be reliable, but of little use to those who have had to make decisions in the interim.

Understandability

Information should be presented in a way that is readily understandable by users who have a reasonable knowledge of business, economic activities and accounting and who are willing to study the information diligently. Disclosures make the information understandable.

Assignment Questions

Q. 1

The underlying assumption in preparing financial statements is 'Going Concern'. State which ONE of the following best explains this concept.

a) An entity has no intention to liquidate but can curtail major operations if management decides
b) The financial statements of an entity should be user friendly
c) An entity should continue in operation for the foreseeable future
d) Transactions and events of an entity should be recorded for the foreseeable future

Q. 2

Which of the following is the best description of fair presentation in accordance with IAS 1 Presentation of Financial Statements?

a) The financial statements are accurate
b) The financial statements are as accurate as possible given the accounting systems of the organization
c) The directors of the company have stated that the financial statements are accurate and correctly prepared
d) The financial statements are reliable in that they reflect the effects of transactions, other events and conditions

Q. 3

For the purpose of fair presentation, the requirement of IAS 1 can be stated as which of the following?

i. Selection and application of accounting policies
ii. Presentation of information in a manner which provides relevant, reliable, comparable and understandable information
iii. Additional disclosures where required

a) (i) and (ii) only
b) (ii) and (iii) only
c) (i) and (iii) only
d) (i), (ii) and (iii)

Examination Questions

Q. 1

Briefly describe the fundamental and enhancing characteristics of useful financial information (marks 3)

Q. 2

Enumerate different users of financial statements (marks 3)

Q. 3

What are the two recognition criteria for Assets?

Chapter – 2

Recording Financial Information
Double Entry Bookkeeping System – Accounting Equation

Sr. No	Course outline – Topics
1	Types of Transactions - Cash and Credit Transactions
2	Identifying Debtors and Creditors
3	Accounting Equation - Concepts
4	Accounting Equation - Worked Example
5	Accounting Equation - Practice

Topic Videos 012-016 are mandatory part of this module

Sources of financial information

As discussed earlier Financial information means the information that can be measured in terms of **money**

There are three sources of financial information:

1. Transactions
2. Events
3. Conditions

We shall put special concentration to identify and analyze "**transactions**" for recording purposes in the books of accounts.

Types of transactions

There are two types of transactions:

1. Cash Transactions

2. Credit Transactions

Cash transaction

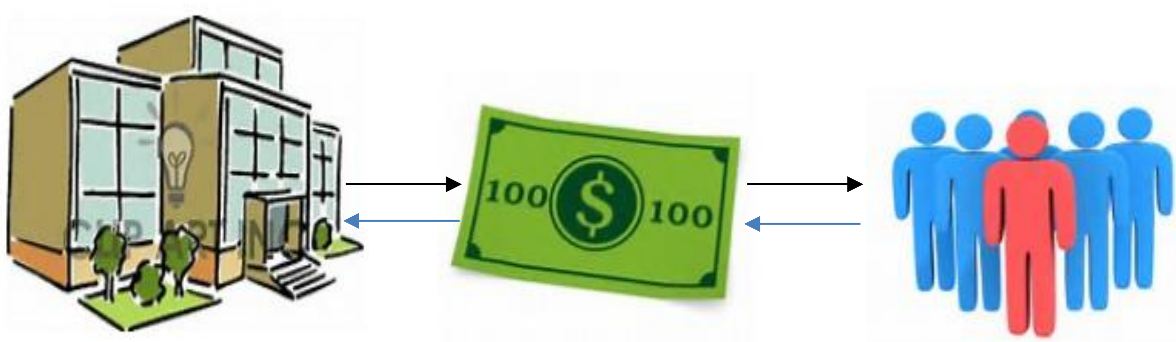
Cash transaction means the transaction in which cash/cheque is either paid or received at the same time while entering into the transaction. Examples include:

1. Cash received from customers/debtors/accounts receivables.
2. Cash paid to supplier/creditors/accounts payables.
3. Staff salaries paid through cheques.
4. Service fee received in cash.
5. Any type of payments made by cash/cheques/standing order/direct debit/debit card/demand draft etc.
6. Any type of collections received in cash/cheques / credit transfer in the bank etc.

Goods sold/Service provided

Supplier **Customer**

Payment



Credit transaction

Credit transaction means a transaction in which payment or receipt in terms of cash or any other financial instrument is deferred for some future period. Means payment will be made or collection will be received sometime in future.

Examples include:

1. Sales of goods on credit by issuing sales invoice.
2. Purchase of goods on credit by receiving purchase invoice.
3. Return of goods from customers and issuing credit note.
4. Return of goods to suppliers and receiving credit note.

(A credit transaction creates Accounts Receivable - DEBTOR for supplier & Accounts Payable - CREDITOR for Customer)

Goods sold/Service provided

Supplier **Customer**

Commitment to pay in future

(Based on Invoice)

Identifying Debtors and Creditors

- Each **cash transaction** causes an increase or decrease in the cash balance / bank balance

After transaction increase

Before transaction

After transaction decrease

- Each **credit transaction** either creates accounts receivable also known as **debtor,** or accounts payable also known as **creditor**. These personal accounts represent the transactions with Customers and Suppliers

For Example:
An entity (customer) buys goods from supplier without making cash payment. This transaction creates a commitment on customer for supplier which is recorded as a liability and is recognized as Account Payable (Creditor) in the books of customer.
OR
An entity (supplier) sells goods to its customer without receiving cash. This transaction creates a commitment to receive cash from its customer which is recorded as an asset and is recognized as Account Receivable (Debtor) in the books of supplier.

Goods moving from Supplier	⇒	**to Customer**
Cash moving from Customer	⇒	**to Supplier**

Debtors (Accounts Receivables) – ASSETS

These are the customers to whom goods/services are sold on credit terms based on a commitment that they will pay money in future. In other words, Debtors owe money to the business therefore, they are treated as accounts receivables.

Examples include:

⇒ Goods sold to **Yasmin** on credit terms. (**credit** transaction)

⇒ Cash received from **Yasmin** after 1 month of sales. (**cash** transaction)

Here, **Yasmin** (in the above two examples) is accounts receivable (debtor) for the entity.

- In the first transaction entity sold goods to **Yasmin** on credit, this creates a commitment for collection of money in future from **Yasmin**.
- In the second transaction entity is collecting cash from **Yasmin**, who is fulfilling the past commitment.



Creditors (Accounts Payable) – LIABILITIES

These are the suppliers from whom the goods/services are purchased on credit term based on a commitment that they will be paid in future, in other words business owes money to the Creditors therefore, they are treated as accounts payables.

Examples include;

⇒ Goods purchased from **Maryam.** (**credit** transaction)

⇒ Paid cash to **Maryam** After one month of purchase. (**cash** transaction)

Here, **Maryam** (In the above two examples) is accounts payable (creditor) for the entity.

- In the first transaction entity bought goods from **Maryam** on credit, this creates a commitment for payment of money in future to **Maryam**.
- In the second transaction entity is paying cash to **Maryam** in order to fulfill the past commitment.




Practice 2.1

Identify which of the followings is a cash or credit transaction, **also** identify the personal account as Debtor or Creditor from the following transactions.

(a) Purchased goods from Hanan on credit.

- Credit transaction
- Cash transaction
- Hanan is Debtor – Accounts Receivable
- Hanan is Creditor – Accounts Payable

(b) Paid cash to Maria on account.

- Cash transaction,
- Credit transaction,
- Maria is Debtor – Accounts Receivable,
- Maria is Creditor – Accounts Payable

(c) Received cash from Star Brothers on account.

- Cash transaction,
- Credit transaction,
- Star Brothers is Debtor – Accounts Receivable,
- Star Brothers is Creditor – Accounts Payable

(d) Paid cash to Donald on account.

- Cash transaction,
- Credit transaction,
- Donald is Debtor – Accounts Receivable,
- Donald is Creditor – Accounts Payable

(e) Sold goods to John Smith on credit.

- Cash transaction,
- Credit transaction,
- Smith is Debtor – Accounts Receivable,
- Smith is Creditor – Accounts Payable

(f) Purchased goods from Michael & Co.

- Cash transaction,
- Credit transaction,
- Michael & Co is Debtor – Accounts Receivable,
- Michael & Co is Creditor – Accounts Payable

Answer

a. **Credit transaction – Creditor**
b. **Cash transaction – Creditor**
c. **Cash transaction – Debtor**
d. **Cash transaction – Creditor**
e. **Credit transaction – Debtor**
f. **Credit transaction – Creditor**

Explanation to the correct answer:

a. The person from whom goods are purchased on credit is "creditor – accounts payable".
b. Cash payment is made on account against credit purchase in previous dates
c. Cash is received on account from customer against credit sale to customer in previous dates
d. The person to whom money is paid on account is "creditor"
e. The person to whom goods are sold on credit is "debtor"
f. The person from whom goods are purchased on credit is "creditor".

Practice 2. 2

Identify which of the followings is a cash or credit transaction, **also** identify personal account as a Debtor or Creditor in the following transactions.

1. Bought motor car for cash.
2. Paid creditor Donald by cash.
3. Paid cash to Meera on account.
4. Sold motor car for cash to Dawood.
5. Bought furniture on credit from Henry.
6. Received cash from Star Brothers on account.
7. Owner Hamesh introduced further cash into the business.
8. Loan in cash received from Jasmin.
9. Paid Richard by cheque on account.
10. Sold goods on credit to Nelson.
11. Received Loan from Commercial Bank

Answer

1. Cash transaction – No Debtor or Creditor
2. Cash transaction – Donald is creditor
3. Cash transaction – Meera is creditor
4. Cash transaction – No Debtor or Creditor
5. Credit transaction – Henry is creditor
6. Cash transaction – Star Brothers is debtor
7. Cash transaction – No Debtor or Creditor
8. Cash transaction – No Debtor or Creditor
9. Cash transaction – Richard is creditor
10. Credit transaction – Nelson is debtor
11. Cash transaction – No Debtor or Creditor

Explanation:

1. Cash is paid against asset-motor car
2. The person to whom money is paid on account is “creditor”
3. The person to whom money is paid on account is “creditor”
4. Cash is received from selling an asset
5. The person from whom assets or goods are purchased on credit is “creditor”
6. The person from whom money is received on account is “debtor” because we have had sold goods or asset to him on credit in the past
7. Cash is received from owner, Hamesh is not a creditor
8. Cash received as loan, any person who provides loan is not a creditor but will be recognized as liability.
9. The person to whom money is paid on account is “creditor”
10. The person to whom goods are sold on credit is called “debtor”
11. Cash received as loan, provider of loan is not a creditor but will be recognized as liability.

When cash is received as loan, that provider does not become creditor although that person is treated as a liability. ***Creditors*** *are the suppliers of goods or services on credit terms.*

ACCOUNTING EQUATION

The concept of double entry accounting system is based on an equation that is initially **"0 = 0"**, subsequently each financial information causes a change in this equation, which results into following effects in terms of **+ or – :**

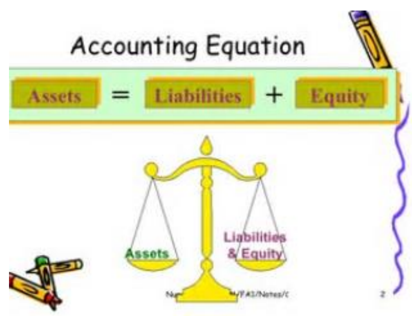
i. increase in left side and also increase in right side **(+ = +)** or
ii. decrease in both sides **(- = -)** or
iii. increase in one side and decrease in the same side **(± = 0)** or **(0 = ±)**

With the help of accounting equation it becomes easy to understand that each financial information has two fold effects. Basic accounting equation is: **(Resources = Sources)**.

When a business is started, initially it needs **resources**; such resources are taken from its Owners and can also be borrowed from Lenders as a **sources** of finance.

In accounting the resources *controlled* by a business are **assets** and sources of such inputs are **owner's equity** and **liabilities**. So, we can amend the above equation as:

(Assets = Owner's Equity + Liabilities)



From the above equation it is understood that both sides will always give equal sum. This happens because we are treating the same transaction from two aspects i.e.

1. What are the resources (assets), and




2. What are the sources of such resources (Owners Equity and Liabilities)


Recalling the previous knowledge; we have discussed five main heads of accounts, among those three heads are appearing in the equation. Whereas, two heads i.e., expenses and incomes are missing.
These two heads constitute profit of the entity
Incomes – Expenses = Profit
Profit also contributes as a source of acquiring assets in the business.

Resources appearing at left side of the equation are financed by **external sources** as well as **internal sources** that appear at the right side of the equation.
External sources are provided by Owners and Lenders, whereas internal sources are generated by the business itself by way of earning profits.

Profit = Incomes – Expenses

Profits earned by the business are included in Owners' Equity, which are paid to the owners for personal use (known as drawings/dividends).

Following equation makes this concept clear:

Owner's Equity = Capital + Profit (– loss) – Drawings

In the following section we shall learn through a detailed worked example that how different transactions affect the accounting equation.

You will find it very interesting because of its mathematical wizard; that both sides of equation shall remain equal.

Worked example

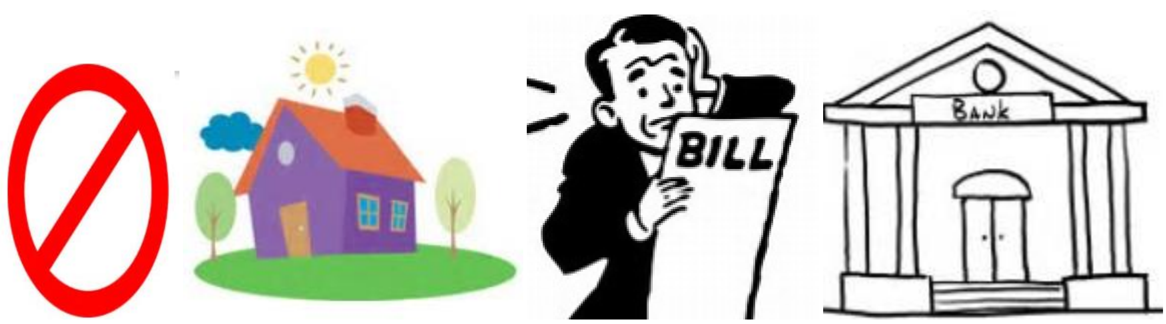
Transaction 1: Henry started business, Micro Logics, by introducing capital Rs. 45,000 in cash.

The effect of this transaction is to increase the asset-cash (on left side of the equation) by Rs. 45,000, in order to balance the equation; the owner's equity (on right side of the equation) is increased by the same amount. The owner's equity is referred by using the "owner's name" and "capital", such as "Henry's capital". The effect of this transaction on Micro Logics accounting equation is below.

		Assets					Owner's Equity		Liabilities	
Sr #	Cash	Furniture	Computer	Stock	Debtors	=	Henry Capital	Profit	Bills payable	Creditors
1	45,000						45,000			

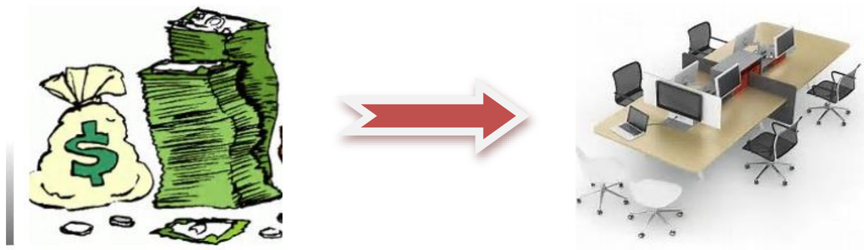
Henry is the sole owner of the business, Micro Logics is a sole proprietorship business.

Above accounting equation relates only to the business "Micro Logics". Under the business entity concept, Henry's personal assets such as a home or personal bank account, and personal liabilities are excluded from the equation.



Transaction 2: Micro-Logics purchased **furniture** by paying **cash** Rs. 20,000.

The purchase of furniture changes make up of the assets, but does not change the total amount of assets. Its effects in the equation are below:



		Assets					**Owner's Equity**		**Liabilities**	
Sr #	Cash	Furniture	Computer	Stock	Debtors	=	Henry's Capital	Profit	Bills payable	Creditors
1.	45,000						45,000			
2.	-20,000	20,000								
	25,000	**20,000**					**45,000**			

Transaction 3: Micro Logics purchased a **computer** for Rs. 28,000 by paying Rs. 8,000 in **cash** and signing a **promissory note** agreement with with supplier for Rs. 20,000.

This transaction changes the assets and also adds a liability at right side of the equation. See below for its effects in the equation.

Assets							Owner's Equity		Liabilities	
Sr #	Cash	Furniture	Computer	Stock	Debtors	=	Henry's Capital	Profit	Bills payable	Creditors
1.	45,000						45,000			
2.	-20,000	20,000								
3.	-8,000		28,000						20,000	
	17,000	**20,000**	**28,000**				**45,000**		**20,000**	

Transaction 4: Micro Logics entered into a transaction of buying stocks/inventory of Rs. 1,350 and agreed **to pay the supplier in near future**.

In this transaction, the liability created is known as creditor and the Items such as stock/inventory that will be used for the business in future is asset. The effect of this transaction is to increase assets and liabilities by Rs. 1,350 as shown here;



Assets							**Owner's Equity**		**Liabilities**	
Sr #	Cash	Furniture	Computer	Stock	Debtors	=	Henry's Capital	Profit	Bills payable	Creditors
1.	45,000						45,000			
2.	-20,000	20,000								
3.	-8,000		28,000						20,000	
4.				1,350						1,350
	17,000	**20,000**	**28,000**	**1,350**			**45,000**		**20,000**	**1,350**

Transaction 5: During its first month of operations, Micro Logics provided **services** to customers, earning fee of Rs. 7,500 and receiving the amount in **cash**.

The receipt of cash increases assets and also increases Henry's equity by Rs. 7,500, as shown in the equation.

Assets							**Owner's Equity**		**Liabilities**	
Sr #	Cash	Furniture	Computer	Stock	Debtors	=	Henry's Capital	Profit	Bills payable	Creditors
1.	45,000						45,000			
2.	-20,000	20,000								
3.	-8,000		28,000						20,000	
4.				1,350						1,350
5.	7,500							7,500		
	24,500	**20,000**	**28,000**	**1,350**			**45,000**	**7,500**	**20,000**	**1,350**

Transaction 6: For Micro Logics, the expenses paid during the month were as follows:
Wages Rs. 2,125
Rent Rs. 800
Utilities Rs. 450
Miscellaneous Rs. 275
Miscellaneous expense includes petty amounts paid for items like; postage, coffee, and magazine etc.

Effect of this group of transactions is opposite to the effect of revenues. These transactions reduce cash and owner's equity, as shown here:

Assets						Owner's Equity			Liabilities	
Sr #	Cash	Furniture	Computer	Stock	Debtors.	=	Henry's Capital	Profit	Bills payable	Creditors
1.	45,000						45,000			
2.	-20,000	20,000								
3.	-8,000		28,000						20,000	
4.				1,350						1,350
5.	7,500							7,500		
6.	-3,650							-2,125		
								-800		
								-450		
								-275		
	20,850	**20,000**	**28,000**	**1,350**			**45,000**	**3,850**	**20,000**	**1,350**

Transaction 7: Micro Logics **paid** Rs. 950 to its **creditors** during the month.

It reduces both assets and liabilities, as shown here:

Assets							Owner's Equity		Liabilities	
Sr #	Cash	Furniture	Computer	Stock	Debtors	=	Henry's Capital	Profit	Bills payable	Creditors
1	45,000						45,000			
2	-20,000	20,000								
3	-8,000		28,000						20,000	
4				1,350						1,350
5	7,500							7,500		
6	-3,650							-2,125		
								-800		
								-450		
								-275		
7	-950									-950
	19,900	**20,000**	**28,000**	**1,350**	**1,200**		**45,000**	**3,850**	**20,000**	**400**

Transaction 8: During the month Micro Logics **sold** out **stock costing** Rs. 800 for Rs. 1,200 on credit terms, earning a **profit** of Rs. 400.

Sale on credit creates Debtors as asset, whereas in the asset side there is a decrease in stock for Rs. 800. Profit resulting from this transaction will cause an increase in owner's equity with Rs. 400. As shown here;

Assets							**Owner's Equity**		**Liabilities**	
Sr. #	Cash	Furniture	Computer	Stock	Debtors	=	Henry's Capital	Profit	Bills payable	Creditors
1.	45,000						45,000			
2.	-20,000	20,000								
3.	-8,000		28,000						20,000	
4.				1,350						1,350
5.	7,500							7,500		
6.	-3,650							-2,125		
								-800		
								-450		
								-275		
7.	-950									-950
8.				-800	1,200			400		
	19,900	**20,000**	**28,000**	**550**	**1,200**		**45,000**	**4,250**	**20,000**	**400**

Transaction 9: At the end of month, Henry withdrew Rs. 2,000 cash from the business for personal use.

This transaction is exactly opposite to the capital introduced in business by the owner. Cash and owner's equity, both decrease because of cash drawings. As shown here:

Assets							Owner's Equity		Liabilities	
Sr. #	Cash	Furniture	Computer	Stock	Debtors	=	Henry's Capital	Profit	Bills payable	Creditors
1.	45,000						45,000			
2.	-20,000	20,000								
3.	-8,000		28,000						20,000	
4.				1,350						1,350
5.	7,500							7,500		
6.	-3,650							-2,125		
								-800		
								-450		
								-275		
7.	950									-950
8.				-800	1,200			400		
9.	-2,000							-2,000*		
	17,900	**20,000**	**28,000**	**550**	**1,200**		**45,000**	**2,250**	**20,000**	**400**

*Solved example presented two columns for owner equity head i.e., capital and profit. Drawing is not the expense and it should not be treated to reduce the income because drawing is not a contra account of income/revenue. Drawing is basically treated as appropriation/distribution of profit and reduces the amount of profit. Profit becomes the part of owners' equity; ultimately the drawing indirectly reduces the owner equity. You can directly reduce the amount of drawing from owner's equity/capital if use one column of capital to solve the questions of accounting equation. Please note that Drawings account is a contra account of capital.

End of Accounting Equation – Worked Example

Exercise Questions

Choose the possible effects of following transactions on accounting equation.

1. Goods purchased on credit
   - **increase asset,**
   - decrease asset,
   - **increase liability,**
   - decrease liability,
   - increase equity,
   - decrease equity
2. Paid utility bills
   - increase asset,
   - **decrease asset,**
   - increase liability,
   - decrease liability,
   - increase equity,
   - **decrease equity**
3. Sold goods on profit of Rs.200
   - **increase asset,**
   - **decrease asset,**
   - increase liability,
   - decrease liability,
   - **increase equity,**
   - decrease equity
4. Paid to supplier of good on account
   - increase asset,
   - **decrease asset,**
   - increase liability,
   - **decrease liability,**
   - increase equity,
   - decrease equity
5. Cash invested by owner
   - **increase asset,**
   - decrease asset,
   - increase liability,
   - decrease liability,
   - **increase equity,**
   - decrease equity
6. Owner buys a new car from personal resources **(No Effect)**
   - increase asset,
   - decrease asset,
   - increase liability,
   - decrease liability,
   - increase equity,
   - decrease equity
7. Goods lost in fire
   - increase asset,
   - **decrease asset,**
   - increase liability,
   - decrease liability,
   - increase equity,
   - **decrease equity**
8. Goods taken by owner for personal use
   - increase asset,
   - **decrease asset,**
   - increase liability,
   - decrease liability,
   - increase equity,
   - **decrease equity**

9. Loan taken from commercial bank
    - **increase asset,**
    - decrease asset,
    - **increase liability,**
    - decrease liability,
    - increase equity,
    - decrease equity
10. Received commission
    - **increase asset,**
    - decrease asset,
    - increase liability,
    - decrease liability,
    - **increase equity,**
    - decrease equity

Correct answers:

1. Increase asset, increase liability
2. Decrease asset, decrease equity
3. Decrease asset, increase asset ,increase equity
4. Decrease asset, decrease liability
5. Increase asset, increase equity
6. No effect
7. Decrease asset, decrease equity
8. Decrease asset, decrease equity
9. Increase asset, increase liability
10. Increase asset, increase equity

Explanation:

1. Increase asset-stock of goods, increase liability creditors
2. Decrease asset-cash , decrease equity because of expense of utility bills
3. Decrease asset-stock at cost, increase asset cash with sale price ,increase equity with profit
4. Decrease asset-cash, decrease liability creditor
5. Increase asset-cash, increase equity by capital amount invested by owner
6. No effect-its owner personal transaction
7. Decrease asset-stock, decrease equity with loss amount
8. Decrease asset-stock, decrease equity by drawings made by owner
9. Increase asset-cash, increase liability-loan from bank
10. Increase asset-cash, increase equity-for income

Examination Questions

1. The owner puts RS.10,000 into a separate bank account for the business:
2. The business buys a shop for RS.2,000 paid in cash
3. The business buys goods for resale (in cash) for RS.1,000
4. The business buys more goods for resale (on credit) for RS.2,000
5. The business buys a car for RS.3,000 (cash)
6. The business sells half of the goods for RS.2,400 (cash)

Correct answers:

1. Increase asset, increase equity
2. Increase asset, decrease asset
3. Increase asset, decrease asset
4. Increase asset, increase liability
5. Increase asset, decrease asset
6. Decrease asset, increase asset, increase equity

Chapter – 3

Rules of Debit and Credit
Preparation of voucher with supporting documents

Sr. No	Course outline Topics
1	Concept of Debit and Credit (Dr. and Cr.)
2	Types of Account - Elements of Financial Statements
3	Analyzing Dr. & Cr.
4	Concept of Main Head and Accounting Head - Practice
5	Double entry accounting system - Practice
6	Double entry accounting system – Practice
7	Concept of Voucher
8	Concept of Source Documents
9	Different types of books of accounts
10	Accounting systems - Cash Basis Vs. Accrual Basis
11	Single entry accounting Vs Double entry accounting

Topic Videos 017-027 are mandatory part of this module

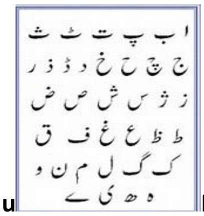
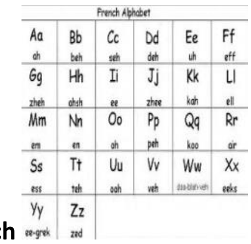
Rules of Debit & Credit

Concept of Debit and Credit – (Dr. and Cr.)

Each language has unique alphabets which are used to create words and to give sense to the ideas or information. In the same way, Accounting as a language also carries unique alphabets that are used to give sense to the financial information, these are two in count.

1. **Debit – Debere in Latin – denoted by Dr.**
2. **Credit – Credere in Latin – denoted by Cr.**

English 

Urdu 
French 
Accounting 

Here one should not ignore that alphabets of all the languages (inclusive of Accounting) do not carry any meaning but the alphabets are used to compose words for expressing an ideas or information. In accounting language "Dr." and "Cr." are the alphabets that are used to record financial information in the books of accounts. Dr. and Cr. are also termed as tools of accounting.

For the purpose of developing rules for Dr. and Cr., elements of financial statements are further distinguished into two groups. This division is done based on their nature.

1. **Debit Group**
2. **Credit Group**

Debit Group *consists of*	**Credit Group** *consists of*
1. Assets 2. Expenses	1. Owner's Equity 2. Liabilities 3. Incomes




Assets

Expenses **O. Equity** **Liabilities** **Incomes**

Characteristically; the members of Dr. Group carry same nature i.e., derivation of these two heads materializes when resources have been expended in the past or will be expended in future.
Whereas, derivation of the three heads in Cr. Group happens when resources have been received in the past or will be received in future.

Types of Account

Before discussing the rules of Dr. and Cr., it is important to understand different types of "account". This is because, while recording financial information we have to identify the correct "account" to be recognized as Dr. or Cr.

"Account" is a terminology that is used for an individual record of similar transactions in a summarized form, belonging to any of the five main heads i.e., asset, liability, income, expense and owner's equity.

An account is a further division of the elements of financial statements (main heads) so that the financial statements are understood in elaborated way. For example; *cash* is an account under the main head of asset, *creditor* is an account under the main head of liability.

This division of the elements of financial statements (main heads) is known as modern approach of identifying types of accounts. According to the modern approach of accounting, there are five types of accounts; <u>*asset*</u>, <u>*liability*</u>, <u>*income*</u>, <u>*expense*</u>, <u>*owner's equity*</u>.

Conventionally accounts were divided into three types; <u>*personal*</u>, <u>*real*</u>, <u>*nominal*</u>.

1. **Personal Account**

   Accounts which are related to persons or institutions dealing with the entity, for example; debtors, creditors or banks.

2. **Real account**

   Accounts which are related to properties or possessions related to the entity, for example; furniture, buildings, cash.

3. **Nominal Account**

   Accounts which are related to expenses, income, losses and gains of the entity, for example; sales, purchases, salary, utility bills etc.

Important Note:

In this course we shall follow the modern approach to learn the rules of Dr. and Cr.

Analyzing "Debit and Credit"

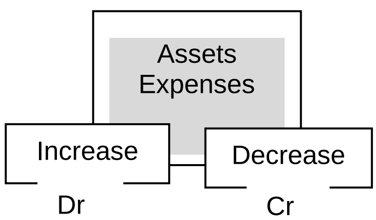
Remember the algebraic rule of addition and subtraction; increase in a figure is brought-in through the same sign whether negative (-ve) or positive (+ve) whereas; decrease in a figure is brought-in through the opposite sign whether negative (-ve) or positive (+ve).

Hence, in the same way:

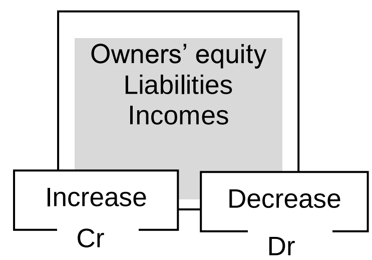
Increase (+) in the items of Debit group	***is brought in***	***through "Dr"***
Decrease (-) in the items of Debit group	***is brought in***	***through "Cr"***
Increase (+) in the items of Credit group	***is brought in***	***through "Cr"***
Decrease (-) in the items of Credit group	***is brought in***	***through "Dr"***

Increase in Assets & Expenses	Dr.
Decrease in Assets & Expenses	Cr.
Increase in Equity, Liabilities & Income	Cr.
Decrease in Equity, Liabilities & Income	Dr.

Debit Group



Credit Group



Main Heads	Nature	Increase	Decrease
Assets	Dr	Dr	Cr
Expenses	Dr	Dr	Cr
Owners' Equity	Cr	Cr	Dr
Liabilities	Cr	Cr	Dr
Incomes	Cr	Cr	Dr

Debit	**Credit**
⇑ Assets	⇓ Assets
⇑ Expenses	⇓ Expenses
⇓ O Equity	⇑ O Equity
⇓ Liabilities	⇑ Liabilities
⇓ Incomes	⇑ Incomes

Important Tips To Remember (ITTRs)

⇒ Each financial information causes a monetary change (increase or decrease) in the five **main heads of accounts**. Such change is recorded (translated) into accounting language using its alphabets *"Dr"* & *"Cr"*.

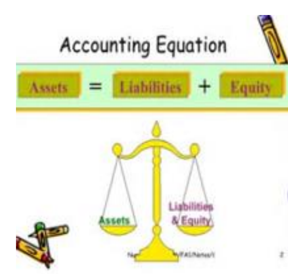
⇒ *"Dr"* or *"Cr"* does not carry literal meanings, just like alphabets of other languages.

⇒ Each transaction causes a change in two **accounting heads**, one change (increase or decrease) is analyzed as *Dr* and second change (increase or decrease) is analyzed as *Cr*. Both changes carry equal weight in terms of monetary effects. That's why accounting is said to be based on double entry concept.

⇒ Often the beginners of accounting studies confuse the terms **Main Heads** with **Accounting Heads.** In order to resolve this ambiguity, go through the following table:

Main Heads	Assets	Expenses	Owners' Equity	Liabilities	Incomes
Accounting Heads	Land	Purchases	Capital	Bank Loan	Sales
	Building	Salaries	Drawings	Bank Overdraft	Interest
	Machinery	Electric Bill	Profits	Creditors	Commission
	Furniture	Repair	etc.	Accounts Payable	etc.
	Motor Van	Advertisement		etc.	
	Computer	Commission			
	Stocks	Traveling			
	Debtors	Freight			
	Cash Balance	Rent			
	Bank Balance	Stationery			
	etc.	etc.			

⇒ **Important Accounting equations**



(i) Σ Dr = Σ Cr

(ii) Resources = Sources

(iii) Assets = Owners' Equity + Liabilities

(iv) Owners' Equity = Capital + Profit – Loss – Drawings

(v) Profit/Loss = Incomes – Expense

Practice 3.1

Identify two accounting heads from each transaction and place it under the appropriate main head.

Transaction 1: Bought a building for cash.
a) Bought b) Building c) Cash d) Expense

Transaction 2: Paid salaries to staff in cash.
a) Paid b) Staff c) Cash d) Salary

Transaction 3: Goods sold on credit to Dar Brothers.
a) Creditor b) Sales c) Cash d) Debtor

Transaction 4: Cash introduced by the owner as a capital.
a) Investment b) Cash c) Capital d) Owner

Transaction 5: Commission received in cash
a) Receiving b) Cash c) Equity d) Commission

Transaction 6: Purchase goods for cash.
a) Stock b) Cash c) Purchases d) goods

Transaction 7: Cash withdrew by the owner for personal use.
a) Drawings b) Cash c) Owner d) Goods

Transaction 8: Rent paid by cheque.
a) Rent b) Cash c) Bank d) Goods

(Greens are correct)

Answer:

Transaction	Assets	Expenses	Owner's Equity	Liabilities	Incomes
1	b) Building				
	c) Cash				
2	c) Cash	d) Salary			
3	d) Debtors				b) Sales
4	b) Cash		c) Capital		
5	b) Cash				d) Commission
6	b) Cash	c) Purchases			
7	b) Cash		a) Drawings		
8	c) Bank	a) Rent			

Double Entry Accounting System

As discussed earlier, each transaction causes increase or decrease in two accounting heads. While doing bookkeeping (recording transaction in the books of accounts) we have to show these two effects on each of the two relevant accounting heads. Increase or decrease caused by a transaction in two accounting heads is recorded in terms of *Dr* and *Cr*. The core concept of double entry bookkeeping is that each transaction is recorded twice.

Practice 3.2

From the following transactions, identify relevant accounting heads along with their respective main heads and also show increase or decrease in the **main heads** to make decision for Dr and Cr effects.

1. Capital introduced in the business Rs.10,000.
2. Purchase furniture for cash Rs.4,000.
3. Purchase goods for cash Rs. 2,000.
4. Sold goods for cash Rs.3,000.
5. Rent paid in cash Rs.2,000.
6. Owner withdrew cash for personal use Rs.500.
7. Salaries paid in cash Rs.200.
8. Bought goods from John Smith on credit Rs.6,000.
9. Sold goods on credit to Henry for Rs.8,000.
10. Received cash from Donald Rs.2,500.

Answer:

No.	Accounting Head	Main Head	Group	Increase/decrease	Dr./Cr. Effect
1	Cash Capital	Asset Own. Equity	Dr. Cr.	Inc. Inc.	Dr. Cr.
2	Cash Furniture	Asset Asset	Dr. Dr.	Dec. Inc.	Cr. Dr.
3	Purchases Cash	Expense Asset	Dr. Dr.	Inc. Dec.	Dr. Cr.
4	Cash Sales	Asset Income	Dr. Cr.	Inc. Inc.	Dr. Cr.
5	Rent Cash	Expense Assets	Dr. Dr.	Inc. Dec.	Dr. Cr.
6	Drawings Cash	Own. Equity Assets	Cr. Dr.	Dec. Dec.	Dr. Cr.
7	Cash Salaries	Asset Expense	Dr. Dr.	Dec. Inc.	Cr. Dr.
8	Purchases Creditors (John Smith)	Expense Liability	Dr. Cr.	Inc. Inc.	Dr. Cr.
9	Sales Debtor (Henry)	Income Asset	Cr. Dr.	Inc. Inc.	Cr. Dr.
10	Cash Debtor (Donald)	Asset Asset	Dr. Dr.	Inc. Dec.	Dr. Cr.

Important Tips To Remember (ITTRs)

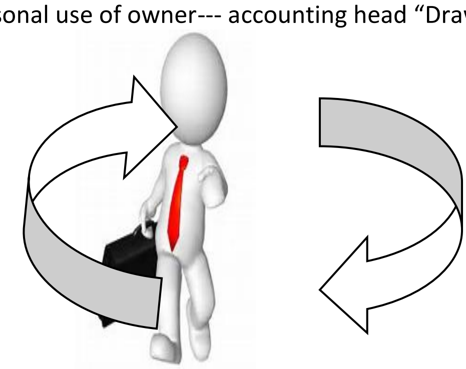
⇒ For purchase of goods--- use “Purchases” as Dr. accounting head (never use goods as accounting head).

✓ Purchases Account
X Goods Account

⇒ For sale of goods--- use “Sales” as Cr. accounting head (never use goods as accounting head).

✓ Sales account
X Goods account

⇒ For personal use of owner--- accounting head “Drawings” is used.



⇒ For goods or cash withdrawn for personal needs --- use “Drawings” as Dr. accounting head

⇒ For investments introduced by owner into the business--- use “Capital” as Cr. accounting head.

Practice 3.3

Not according to the video lecture slides. From the following transactions, identify relevant accounting heads along with their respective main heads and also show increase or decrease in the main heads and then make decision for Dr and Cr effects.

1. Started business with Rs. 10,000 in the bank.
2. Paid insurance by cheque Rs.600.
3. Bought goods from Maria & Co. Rs. 3,000.
4. Paid the month's wages by cash Rs.500.
5.
6. Owner withdrew goods for personal use Rs. 2,000.
7. Sold goods on credit to Stars Bros. Rs. 3000.
8. Bought stationery Rs.300, paying in cash.
9. Owner took cash for himself Rs.200.
10. Cash received from Stars Bros. Rs.3000.

Answer:

Sr. No.	Accounting Head	Main Head	Group	Increase/decrease	Dr./Cr. Effect
1	Bank Capital	Asset Own. Equity	Dr. Cr.	Inc. Inc.	Dr. Cr.
2	Purchases Creditor (Maria & Co.)	Expense Liability	Dr. Cr.	Inc. Inc.	Dr. Cr.
3	Cash Wages	Asset Expense	Dr. Dr.	Dec. Inc.	Cr. Dr.
4	Bank Insurance	Asset Expense	Dr. Dr.	Dec. Inc.	Cr. Dr.
5	Drawings Purchases	Own. Equity Expense	Cr. Dr.	Dec. Dec.	Dr. Cr.
6	Sales Debtor (Stars Bros.)	Income Asset	Cr. Dr.	Inc. Inc.	Cr. Dr.
7	Cash Stationery	Asset Expense	Dr. Dr.	Dec. Inc.	Cr. Dr.
8	Drawings Cash	Own. Equity Asset	Cr. Dr.	Dec. Dec.	Dr. Cr.
9	Cash Debtor (Stars Bros.)	Asset Asset	Dr. Dr.	Inc. Dec.	Dr. Cr.

Important Tips To Remember (ITTRS)

⇒ For payments through cheque use “Bank” as credit accounting head because it decreases bank balance.

Payment by cheque:
- ✓ Bank account
- X Cash account

⇒ Whenever there is a decrease in purchased goods, other than because of sales and purchases return, always use “Purchases” as credit accounting head.

Decrease in stocks

- Loss/destroy
- Free sample
- Charity
- Drawings

→ Purchases – Cr.

Practice 3.4

From the following transactions, identify relevant accounting heads along with their respective main heads and also show increase or decrease in the main heads and then make decision for Dr and Cr effects.

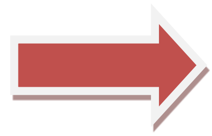
- Machinery purchased from Maria & Co. on credit Rs.2,000.
- Loan taken from friend Rs.200 in cash.
- Machinery returned to Maria & Co. Rs. 2,000.
- Bought goods on credit from Kashmiri Rs. 600.
- Sold goods on credit to Harris Rs.800.
- Goods returned to Kashmiri Rs.100.
- Goods returned by Harris Rs. 200.
- Charity paid in cash Rs. 200.
- Free sampling of goods Rs. 50.
- Friend's loan was repaid Rs. 200.

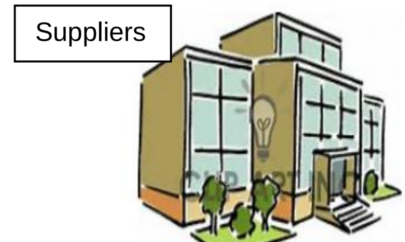
Answer:

Sr. No.	Accounting Head	Main Head	Group	Increase/decrease	Dr./Cr. Effect
1	Machinery	Asset	Dr.	Inc.	Dr.
	Creditors (Maria & Co.)	Liability	Cr.	Inc.	Cr.
2	Cash	Asset	Dr.	Inc.	Dr.
	Loan from friend	Liability	Cr.	Inc.	Cr.
3	Machinery	Asset	Dr.	Dec.	Cr.
	Creditor (Maria & Co.)	Liability	Cr.	Dec.	Dr.
4	Purchases	Expense	Dr.	Inc.	Dr.
	Creditor (Kashmiri)	Liability	Cr.	Inc.	Cr.
5	Sales	Income	Cr.	Inc.	Cr.
	Debtor (Harris)	Asset	Dr.	Inc.	Dr.
6	Purchases Return	Expense	Dr.	Dec.	Cr.
	Creditor (Kashmiri)	Liability	Cr.	Dec.	Dr.
7	Sales Return	Income	Cr.	Dec.	Dr.
	Debtor (Harris)	Asset	Dr.	Dec.	Cr.
8	Cash	Asset	Dr.	Dec.	Cr.
	Charity	Expense	Dr.	Inc.	Dr.
9	Free Sampling	Expense	Dr.	Inc.	Dr.
	Purchases	Expense	Dr.	Dec.	Cr.
10	Cash	Asset	Dr.	Dec.	Cr.
	Loan from friend	Liability	Cr.	Dec.	Dr.

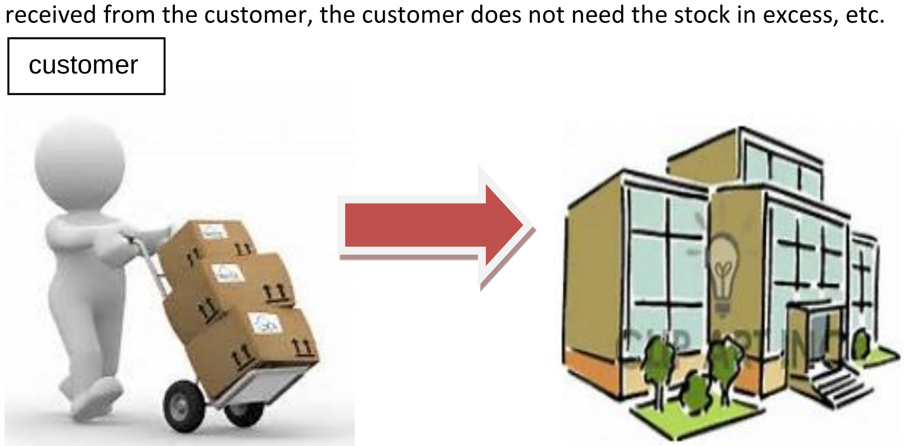
Important tips to remember (ITTRs)

⇒ For faulty goods returned to suppliers (Creditors), use "Purchases Return" as Cr. accounting head.
Purchases return may occur because of multiple reasons like; defects in goods, quality is not matching with the requirement ordered by the entity, the entity does not need the stock in excess.





⇒ For faulty goods returned by customers (Debtors) use "Sales Return" as Dr. accounting head.
Sales return may occur because of multiple of reasons like; defects in goods, quality is not matching the order received from the customer, the customer does not need the stock in excess, etc.



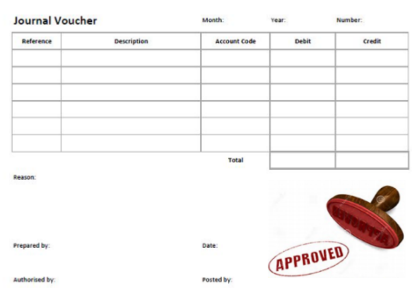
Concept of Voucher and Supporting Documents

Voucher

Voucher is used to recognize two accounting heads along with their values. Voucher is an internal document that is prepared to witness that the transaction is complete and verified, it is supported by needful documents and authorized by appropriate signatories.

Bookkeeper requires documentary evidence with proper approval of the transaction and authorization of the source documents from a concerned authority. For this purpose, all descriptions of the transaction are written on the voucher and supporting documents are attached along with evidences of approvals and authorizations.

Such voucher is then processed by the bookkeeper for its recording in the proper book of original entries.


Journal Voucher Month: Year: Number:

Reference	Description	Account Code	Debit	Credit
		Total		

Reason:

Prepared by: Date:

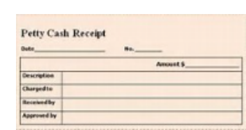
Authorised by: Posted by:

Types of vouchers

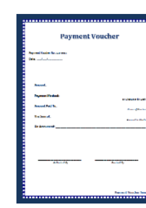
There are different types of vouchers that a bookkeeper prepares depending upon the nature of transactions, other events or conditions.

- **Journal Vouchers**
  A written authorization prepared for each non-cash financial information, or for every transaction that meets defined requirements.

- **Petty Cash Receipt Voucher**
  A statement of spending from petty cash fund for which bill/invoice was not received. Petty cash fund is maintained to provide fast access to small amounts of cash for non-routine expenses. Petty cash vouchers are used to maintain financial control of petty cash account, preventing abuse or mismanagement of the funds.



- **Cash Payment Voucher**
  A document, which is used as proof that a cash payment transaction has occurred between two parties. In business, a payment voucher can be used for a variety of purposes, sometimes taking the place of cash in a transaction, acting as a receipt, or indicating that an invoice has been approved for payment.



- **Bank Receipt & Payment Voucher**
  A bank receipt voucher contains detailed information about transactions involving bank deposits, collection from customers who make payments on account, credit card based sales and other similar types of transactions. Bank payment voucher is a document that is used as a proof of payments made through cheques, pay order, direct debits, standing instructions etc.

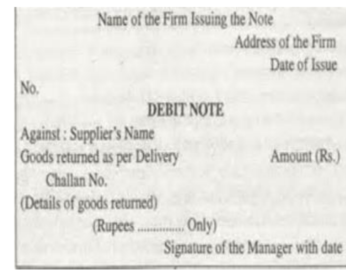
- **Gift Voucher**
  Gift voucher is used to give rights to the customers for buying goods for free or to avail discount as a special offer

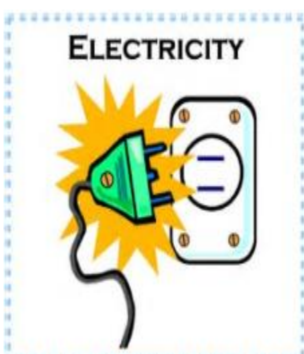
Practice - 3.8

1. Who is responsible to prepare journal voucher?
   a) supplier b) manager c) bookkeeper d) accountant
2. Journal voucher is used to record transaction in?
   a) general journal b) general ledger c) trial balance d) balance sheet
3. Which voucher is used as proof that a significant cash transaction has occurred between two persons?
   a) petty cash voucher b) cash payment voucher c) journal voucher d) gift voucher
4. Which voucher is given by seller to customer that gives right of free shopping or discounts?
   a) petty cash voucher b) gift voucher c) cash payment voucher d) bank payment voucher
5. Which voucher is prepared in support to transaction of collecting money in the bank from customer?
   a) bank receipt voucher b) bank payment voucher c) deposit slip d) bank statement

Source Documents

Sr. No.	Transaction	Source Documents
1	Sales	Invoice (issued) against sales of goods or services on account
2	Purchases	Invoice (received) against purchases of goods or services on account
3	Sales Return	Credit Note (issued) upon accepting the goods returned by customer
4	Purchases Return	Debit Note (issued) / Credit Note (received) upon returning goods to supplier
5	Cash received	Cash Memo/receipt (issued) upon receiving cash
6	Cash paid	Cash Memo/receipt (received) upon making cash payment
7	Leases (Rental etc.)	Agreements signed by the parties to a lease or any other contract
8	Staff Salaries	Payrolls sheet upon transferring salaries and wages to the staff
9	Utility Bills	Metered Bills/Invoices against obtaining economic benefits of the utilities


Name of the Firm Issuing the Note
Address of the Firm
Date of Issue
No.
DEBIT NOTE
Against : Supplier's Name
Goods returned as per Delivery Amount (Rs.)
Challan No.
(Details of goods returned)
(Rupees .... Only)
Signature of the Manager with date

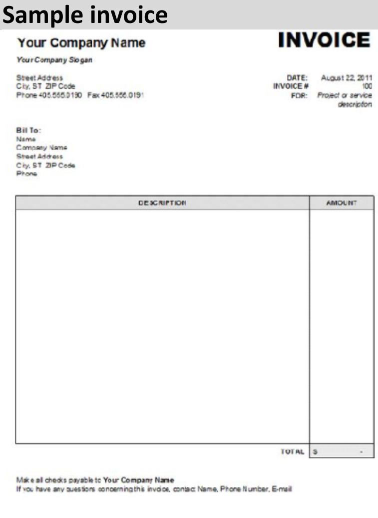


Invoice

An invoice is a document that is prepared by seller and sent to the buyer, it specifies description and amount of products or services provided by the seller.

An invoice describes the amount due on the buyer according to the settlement terms agreed with the seller. Settlement terms usually specify the period of time during which buyer has to pay to the seller for the goods or services purchased.

Sample invoice



Your Company Name

Your Company Slogan

Street Address
City, ST ZIP Code
Phone 405.555.0190 Fax 405.555.0191

INVOICE

DATE: August 22, 2011
INVOICE # 100
FOR: Project or service description

Bill To:
Name
Company Name
Street Address
City, ST ZIP Code
Phone

DESCRIPTION	AMOUNT
TOTAL	$ -

Make all checks payable to **Your Company Name**
If you have any questions concerning this invoice, contact Name, Phone Number, E-mail

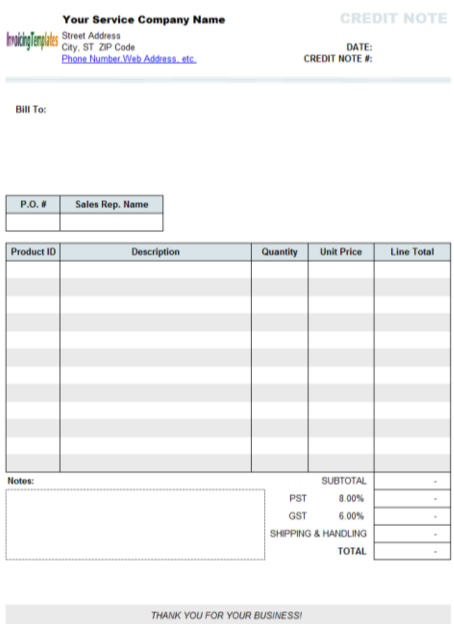
THANK YOU FOR YOUR BUSINESS!

Credit Note

Credit note is a document that is prepared by a seller and sent to the buyer to correct mistake in the original invoice or to reduce the balance due on the buyer for any other reason including the return of goods by buyer to seller.

Credit note describes the reason because of which the buyer’s balance payable to seller is reducing.

Sample credit note



Your Service Company Name
Street Address
City, ST ZIP Code
Phone Number,Web Address, etc.

CREDIT NOTE

DATE:
CREDIT NOTE #:

Bill To:

P.O. #	Sales Rep. Name

Product ID	Description	Quantity	Unit Price	Line Total

Notes:

SUBTOTAL		-
PST	8.00%	-
GST	6.00%	-
SHIPPING & HANDLING		-
TOTAL		-

THANK YOU FOR YOUR BUSINESS!

Recording in the books of accounts

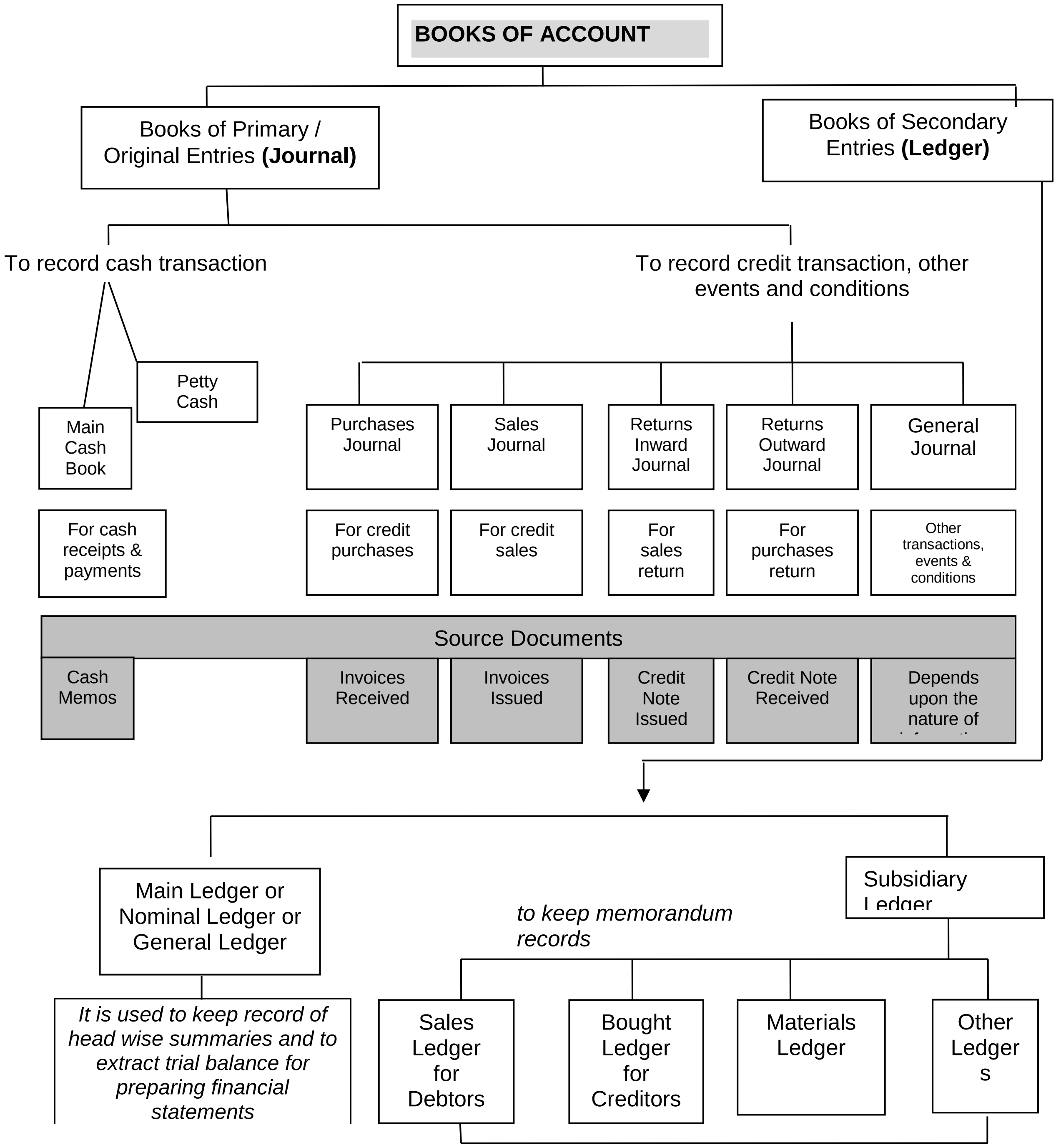
Approved vouchers are recorded in the books of original entries (journals and cashbook), such recorded information is known as “accounting entry”. These accounting entries are then posted into the books of secondary entries (ledgers). Mostly integrated computer software is used for recording and posting transactions. However, an understanding of books of accounts is necessary either transactions are recorded manually or electronically.

There are two types of books of accounts that are used to keep records of financial information of a business entity:

1. Books of original entries.

2. Books of secondary entries.

These books of accounts are further subdivided according to the needs of the business and/or complexity of the transactions. Following diagram best describes the different books of accounts that are used in a business entity.



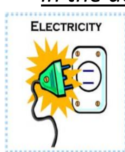
Systems of Accounting/Reporting

There are two accounting systems being practiced:

- **Cash Based Accounting/Reporting System**
  It is a system in which transactions are recorded only when cash is received or paid. The system which reports income when received and expenses when paid.
- **Accrual Based Accounting/Reporting System**
  It is a system in which transactions are recorded on the basis of amount becoming due for payment or receipt, regardless the condition that settlement in terms of cash has happened or not. The only point of concern is, whether the expense or income belongs to the reporting period. If that belongs to the reporting period then payment or collection in terms of cash becomes irrelevant.
  It is the most commonly used accounting method, which reports income when earned and expenses when incurred, as opposed to cash basis accounting, which reports income when received and expenses when paid.
  Under the accrual method, companies do have some discretion as to when income and expenses are recognized, but there are rules governing the recognition.

<u>Example – 1</u>

i. Electricity bill for the last quarter (October – December) was not paid until the end of reporting period 31st December 20X9. **Under the cash-based accounting**; such unpaid utility bill *<u>will not be recognized as expense in the accounting year 20X9</u>*. It will be expense for the year 20Y0 upon payment.




ii. Electricity bill for the last quarter (October – December) was not paid until the end of reporting period 31st December 20X9. **Under the accrual-based accounting**; such unpaid utility expense <u>will be recognized as expense in the accounting year 20X9 along with a liability that will be paid in 20Y0</u>.

Record expense in the books of accounts

Accounting treatment for accrued expense and accrued income:

Expense belongs to the reporting period but its payment will be made in the next year.

Expense head	Dr.	(being economic benefit has been enjoyed during the reporting period)
Liability head	Cr.	(being the amount in terms of cash is still payable)

Income belongs to the reporting period but its receipt will be collected in the next year.

Asset head	Dr.	(being the amount in terms of cash is still receivable)
Income head	Cr.	(being income has been earned by selling goods or rendering services)

<u>Example – 2</u>

Insurance paid in advance for the year 20X9 on 1st November 20X8

Under the accrual-based accounting

The payment of insurance will be recorded in the year 20X8 as "prepayment or paid in advance" which shall be recognized as asset and then in the year 20X9 it will be recorded as expense, to which it belongs to.

Under the cash-based accounting

Payment will be recorded as expense as soon as cash is paid to insurance company on 1st November 20X8

Single Entry Bookkeeping Approach

Single entry bookkeeping is a simplest form of **bookkeeping** in which single effect of each financial information is **entered** in the books of accounts.

Single Entry Bookkeeping -Vs- Double Entry Bookkeeping

The single entry bookkeeping approach contrasts with double entry bookkeeping approach. Each financial information brings at least *two* equal and offsetting entries in the double entry bookkeeping approach. One is debit (Dr) and the other one is credit (Cr). As a result:

- Entities using the double entry approach report financial results with an accrual accounting/reporting system.
- Entities using single entry approach are effectively limited to reporting on a cash basis only.

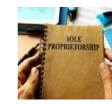
On the positive side, single-entry bookkeeping is simpler and much easier to use than the double entry approach. And, the single-entry approach does not require background or training in accounting. Nevertheless, the overwhelming majority of firms, worldwide, follow double entry not the single-entry approach.

Adequacy of single entry accounting system

Single entry accounting can be adequate for a small business practicing cash based accounting. Small firms may in fact prefer single entry accounting over a double-entry system when all or most of the following conditions apply:

- Entity uses cash based accounting, not accrual accounting.
- There are few financial transactions per day.
- Entity does not sell on its own credit. Customers must pay at the time of the sale either in cash or, by bank transfer, 3rd-party debit card, 3rd-party credit card, or by writing a cheque. The entity does not deliver goods or services and then invoice customers for payment later.

- There are very few employees.
- Entity is privately held or operates as a sole proprietorship or partnership. As a result, the firm does not publish an income statement, balance sheet, or other financial statements that are mandatory for public companies.



Example- single entry system

The single-entry approach is very similar to the cash book that individuals use to keep track of receipts and payments. In both cases, users simply record the date, amount, and name of each transaction. Example below shows how the single-entry record might look for a few days transactions for a very small business.

EXAMPLE: FIVE COLUMN SINGLE ENTRY RECORD

Date	Transaction	Receipts Rs.	Payments Rs.	Balance Rs.
1 December 20X7	Starting balance for the month			4,520.00
2 December 20X7	Utility bills paid		(Rs.43.00)	4 477.00
2 December 20X7	furniture purchased		(Rs.624.15)	3,852.85
3 December 20X7	Sales	Rs.1,040.25		4,893.10
4 December 20X7	tax paid		(Rs.83.22)	4,809.88
4 December 20X7	Commission	Rs.592.25		5,402.13
5 December 20X7	Bank interest received	Rs.180.83		5,582.96
8 December 20X7	Salaries paid		(Rs.42.95)	5,540.01
8 December 20X7	**Ending balance for week**			**5,540.01**

Exercise Question 1

From the following transactions, identify relevant accounting heads along with their respective main heads and also show increase or decrease in the main heads and then make decision for Dr and Cr effects.

1. Machinery purchased from Maria & Co. on credit Rs.2,000.
2. Loan taken from friend Rs.200 in cash.
3. Machinery returned to Maria & Co. Rs. 2,000.
4. Bought goods on credit from Kashmiri Rs. 600.
5. Sold goods on credit to Harris Rs.800.
6. Goods returned to Kashmiri Rs.100.
7. Goods returned by Harris Rs. 200.
8. Charity paid in cash Rs. 200.
9. Free sampling of goods Rs. 50.
10. Friend's loan was repaid Rs. 200.

Answer:

Sr. No.	Accounting Head	Main Head	Group	Increase/decrease	Dr./Cr. Effect
1	Machinery Creditors (Maria & Co.)	Asset Liability	Dr. Cr.	Inc. Inc.	Dr. Cr.
2	Cash Loan from friend	Asset Liability	Dr. Cr.	Inc. Inc.	Dr. Cr.
3	Machinery Creditor (Maria & Co.)	Asset Liability	Dr. Cr.	Dec. Dec.	Cr. Dr.
4	Purchases Creditor (Kashmiri)	Expense Liability	Dr. Cr.	Inc. Inc.	Dr. Cr.
5	Sales Debtor (Harris)	Income Asset	Cr. Dr.	Inc. Inc.	Cr. Dr.
6	Purchases Return Creditor (Kashmiri)	Expense Liability	Dr. Cr.	Dec. Dec.	Cr. Dr.
7	Sales Return Debtor (Harris)	Income Asset	Cr. Dr.	Dec. Dec.	Dr. Cr.
8	Cash Charity	Asset Expense	Dr. Dr.	Dec. Inc.	Cr. Dr.
9	Free Sampling Purchases	Expense Expense	Dr. Dr.	Inc. Dec.	Dr. Cr.
10	Cash Loan from friend	Asset Liability	Dr. Cr.	Dec. Dec.	Cr. Dr.

Exercise Question 2

Choose correct answer

1. Goods purchased from John smith
   a. - cash + stock
   b. + stock + cash
   c. **+ creditors + stock**
   d. b & c both
2. Commission paid to agent Jordan
   a. - commission - cash
   b. **+ commission - cash**
   c. + Jordan Account - cash
   d. + capital - cash
3. Goods sold for Rs.5,000 that cost 4500
   a. **+ cash 5,000 + sales 5,000**
   b. - cash 4,500 - stock 4,500
   c. + cash 5,000 - stock 5,000
   d. +cash 4,500 - sales 4,500
4. Goods returned from credit customer
   a. **- debtors + sales return**
   b. - creditors + stock
   c. + debtors - owner's equity
   d. none of the above
5. Cash received from debtor Rs.4,800
   a. + cash 5,000 + sales 5,000
   b. + cash 4,800 + capital 4,800
   c. **+ cash 4,800 - debtor 4,800**
   d. + cash 4,800 - drawings 4,800
6. Loan repaid to Hassan brothers
   a. - owner's equity + cash
   b. **- liability - cash**
   c. + cash - liability
   d. + Hassan brothers - cash
7. Cash withdraw by owner
   a. + owners' equity - cash
   b. - owners' equity + cash
   c. **- owners' equity - cash**
   d. - owners' equity - stock
8. Machinery purchased from Caterpillar on credit
   a. + machinery - cash
   b. + machinery + cash
   c. **+ machinery + Liability**
   d. - machinery + cash

Answer: (1-c, 2-b, 3-a, 4-a, 5-c, 6-b, 7-c, 8-c)

Examination Question 1

From the following transactions identity two accounting heads and also make decision for Dr and Cr effects.

Jan 1: Capital introduced in the business by owner Rs. 100,000.
Jan 2: Deposited cash into the bank Rs.50,000.
Jan 3: Bought goods on credit from Harris Rs.10,000.
Jan 4: Bought goods from John Smith by paying him cash Rs.5,000.
Jan 5: Stationery paid in cash Rs.500.
Jan 6: Sold goods on credit to Stars bros. Rs.12,000.
Jan 8: Rent expense paid by cheque Rs.2,000.
Jan 9: Furniture and fixture purchased on credit from Charlie Rs.5,000.
Jan 10: Paid salaries Rs.1,000 in cash.
Jan 14: Returned goods to Harris Rs.2,000.
Jan 15: Rent received by subletting the buildings Rs. 6,000.
Jan 16: Received cash from Stars bros. Rs.12,000.
Jan 20: Cash paid to Harris Rs.8,000.
Jan 25: Bought motor car for Rs.30,000 by cheque.
Jan 30: Insurance paid in cash Rs.200.

Answer:

Date	Accounting Head	Dr./Cr. Effect	Amounts
Jan 1	Cash	Dr.	100,000
	Capital	Cr.	100,000
Jan 2	Bank	Dr.	50,000
	Cash	Cr.	50,000
Jan 3	Purchases	Dr.	10,000
	Creditor (Harris)	Cr.	10,000
Jan 4	Purchases	Dr.	5,000
	Cash	Cr.	5,000
Jan 5	Stationery	Dr.	500
	Cash	Cr.	500
Jan 6	Debtor (Stars bros.)	Dr.	12,000
	Sales	Cr.	12,000
Jan 8	Rent	Dr.	2,000
	Bank	Cr.	2,000
Jan 9	Furniture & Fixtures	Dr.	5,000
	Creditor (Charlie)	Cr.	5,000
Jan 10	Salaries	Dr.	1,000
	Cash	Cr.	1,000
Jan 14	Creditor (Harris)	Dr.	2,000
	Purchases (Returns)	Cr.	2,000
Jan 15	Cash	Dr.	6,000
	Rent (Income)	Cr.	6,000
Jan 16	Cash	Dr.	12,000
	Debtor (Stars bros.)	Cr.	12,000
Jan 20	Creditor (Harris)	Dr.	8,000
	Cash	Cr.	8,000
Jan 25	Motor Car	Dr.	30,000
	Bank	Cr.	30,000
Jan 30	Insurance	Dr.	200
	Cash	Cr.	200

Examination Question 2

State whether the following statements are true or false

1. Owner introduced fresh capital during the year will be credited to capital account.
2. Goods given away as charity will be credited to gifts account.
3. Goods Lost by fire will be credited to Purchases account.
4. Cash taken by Proprietor for personal use will be debited to owner's personal account.
5. Loan taken from bank will be credited to creditor account.
6. Salary paid to Mr. John will be debited to Mr. John account

Answer: (1-True, 2-False,3-True, 4-False, 5-False, and 6-False)

Explanation:

2-Goods given away as charity means inventory of goods decreased other than sale, therefore purchases account will be credited

4-when goods or cash taken by owner for personal use than drawings account will be debited his personal account or name will never be used in books of account

5-loan account will be credited as liability, creditors account is used when goods are purchased on credit

6-For expenses, name of expense will be used instead of the person to whom we pay. Debit will be "salary account"

Chapter – 4

Journalizing – Books of Original Entries

Sr. No	Course outline Topic - Chapter 4
1	Journalizing Transactions
2	Journal entry - Practice
3	Compound entry - Practice
4	General Journal - Practice
5	Discounts
6	Journalizing settlement discounts
7	General Journal - Practice with complex accounting entries
8	General Journal - Practice with complex accounting entries
9	Subdivision of Journal
10	Sales Journal
11	Purchase Journal
12	Sales Return Journal
13	Purchase Return Journal
14	Comprehensive practice - subdivision of journal
15	Cash Book
16	Single Column Cash Book
17	Two Column Cash Book
18	Three Column Cash Book
19	Petty Cash Book

Topic Videos 28-46 are mandatory part of this module

Journal / Book of Primary Entry / Book of Original Entry

Journal is the first book in accounting cycle, which is used primarily to record all financial information of the entity. Since the journal is first book of account, therefore, it is also known as book of primary entry or book of original entry.

Financial information comprises of; transactions, events and conditions also known and accounting phenomena. These accounting phenomena are recorded in a chronological (date) sequence. Both accounting effects of a financial information, i.e., Debit & Credit, are analyzed in a voucher and then recorded in journal by following a systematic manner.

Systematic manner of maintaining journal includes proper format and certain rules to be followed. Information recorded by following such rules and in a proper format of journal is known as *journal entry or accounting entry.* Simply it can also be named as *entry*. Just like parts of speech in English language, there are six parts of *entry* in Accounting language; 1) Date, 2) Particulars, 3) Post reference, 4) Debit amount 5) Credit amount, and 6) narration.

The process of maintaining journal is a part of bookkeeping. The person responsible for maintaining journal is known as bookkeeper, who has all the expertise to analyze financial information and to maintain journal.

Recapitulation – Analyzing Dr & Cr

1. Assets (increase debit & decrease credit)
2. Expenses (increase debit & decrease credit)
3. Liabilities (increase credit & decrease debit)
4. Incomes (increase credit & decrease debit)
5. Owners' Equity (increase credit & decrease debit)

Main Heads	**Nature**	**Increase**	**Decrease**
Assets	Dr	Dr	Cr
Expenses	Dr	Dr	Cr
Owners' Equity	Cr	Cr	Dr
Liabilities	Cr	Cr	Dr
Incomes	Cr	Cr	Dr

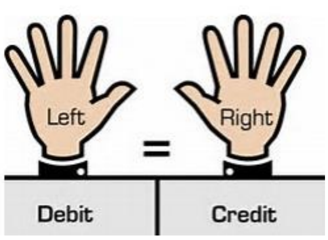
Format of Journal & Journal Entry

For a small entity, which is having very few transactions, events and conditions, a *general-purpose journal* is quite sufficient for recording purposes. Format of a general journal and rules to record journal entry are illustrated below:

Sample Transaction
10 Jan 20X9 Cash paid for staff salaries Rs.50,000

Date 20X9	Particulars/Description	Post Ref.	Debit (Rs)	Credit (Rs)
Jan. 10	Salaries Account *(Debit)*	39	50,000	
	Cash Account *(Credit)*	10		50,000
	(Staff salaries paid in cash)			

- ⇒ From the above illustration we can understand that on *10th January 20X9, business paid cash Rs.50,000 as staff salaries*.
- ⇒ As a rule; it is customary that the accounting head analyzed as *debit* is written firstly in the Particulars/Description column and its amount is written in the debit column whereas the accounting head analyzed as *credit* is written under the debit accounting head but after indenting some space from the left side, its amount is written in the credit column.
- ⇒ The post reference column shows page numbers of the "**Ledger"** in which salaries and cash accounts are posted.
- ⇒ The column of post reference cannot be very well understood without having knowledge of "**Ledger"** that will be learned in the next chapter.
- ⇒ Short explanation of transaction written within the parenthesis in particulars/description column is known as **"Narration"**. It is an integral part of a journal entry. Narration explains accounting treatments to a layman.
- ⇒ Conventionally Debit effects are recorded at left-hand side and Credit effects are recorded at right-hand side.

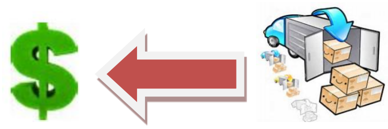


Practice 4.1

Pass journal entries for the following transactions

20X9

Jan. 2: Goods bought for cash Rs.20,000.



Jan. 5: Goods sold for cash Rs.35,000.

Jan. 10: Loan taken from friends in cash Rs.50,000.

Answer:

Date 20X9	**Particulars/Description**	**Post Ref.**	**Debit (Rs)**	**Credit (Rs)**
Jan. 2	Purchases Account *(Debit)* Cash Account *(Credit)* (Bought goods for cash). Explanation: This transaction increased expenses on purchase of goods, therefore debit is given to purchases account and cash-asset decreased therefore credit is given to the cash account.	? ?	20,000	 20,000
Jan. 5	Cash Account *(Debit)* Sales Account *(Credit)* (Sold goods for cash) Explanation: This transaction increased the cash-asset therefore cash account is debited and it increased the sales-income, therefore credit sales account.	? ?	35,000	 35,000
Jan. 10	Cash Account *(Debit)* Loan from friend *(Credit)* (Loan taken in cash from friend). Explanation: This transaction increased the cash-asset therefore cash account is debited and it increased loan-liability Loan from Friend is credited.	? ?	50,000	 50,000

Compound Accounting Entry

A business makes multiple transactions in a day in which same accounting head is involved. The single journal entry, which combines multiple journal entries in which same accounting head is repeating, is known as compound entry. For example;

5 Jan 20X9: Cash Rs.7,000 was paid for salaries and cash Rs.1,000 was paid for purchase of stationery.

In this transaction, cash account is to be credited against both, salaries and stationery. If we record these transactions separately, this would be:

Date 20X9	Particulars/Description	Post Ref.	Debit (Rs)	Credit (Rs)
Jan. 5	Salaries account Cash account (Salaries paid in cash) 	? ?	7,000	 7,000
Jan. 5	Stationery account Cash account (Stationery purchased for cash.) 	? ?	1,000	 1,000

In order to avoid double working, we can combine these two entries in one, which is known as compound entry:

Date 20X9	Particulars/Description	Post Ref.	Debit (Rs)	Credit (Rs)
Jan. 5	Salaries account Stationery account Cash account (Salaries paid & Stationery purchased for cash).	? ?	7,000 1,000	 8,000

Practice 4.2

Prepare a journal for the following transactions during January 20X9.

Jan 1: Capital introduced in the business Rs.10,000 in cash and Rs.20,000 as machinery.

Jan 2: Purchase land for cash Rs.4,000.

Jan 3: Purchase goods for cash Rs.2,000 and on credit from Giant Store Rs.7,000.

Jan 4: Sold goods for cash Rs.3,000.

Jan 5: Rent paid in cash Rs.2,000.

Jan 6: Owner withdrew cash for personal use Rs.500 **OR** Paid Rs.500 to owner for his personal use.

Jan 7: Salaries paid in cash Rs.200.

Jan 8 Bought goods from Moon Light on credit Rs.6,000.

Jan 9 Sold goods on credit to Falcons for Rs.8,000 and for cash Rs.4,000.

Jan10: Received cash from Falcons 2,500 on his account.

Date 20X9	Particulars	Post Ref.	Debit (Rs)	Credit (Rs)
Jan. 1	Cash Account Machinery Account Capital Account (Cash & machinery introduced as capital). Explanation Two assets- cash & machinery increased therefore debited and equity is increased therefore capital account is credited.	? ?	10,000 20,000	 30,000
Jan. 2	Land Account Cash Account (Purchased land for cash). Explanation asset- land increased therefore debited and cash-asset is decreased therefore cash account is credited.	? ?	4,000	 4,000
Jan. 3	Purchases Account Cash Account Creditor (Giant Store) (Goods purchased for cash & on credit from Giant Store). Explanation Expense for purchase of goods increased therefore debited purchases account and cash-asset is decreased therefore cash account is credited, also worth 7,000 goods are on credit which increase the liability therefore creditor is also credited	? ?	9,000	 2,000 7,000
Jan. 4	Cash Account Sales Account (Sold goods for cash). Explanation Cash-Asset increased therefore cash account is debited and sales income increased therefore credit sales account	? ?	3,000	 3,000
Jan. 5	Rent Account Cash Account (Rent paid in cash). Explanation Increase in expense is always debit therefore rent account is debited and cash-asset is decreased therefore cash account is credited.	? ?	2,000	 2,000

Jan. 6	Drawings Account Cash Account (Cash withdrew by the owner for personal use). Explanation Whenever owner withdraws cash for personal use drawing account is debited and cash-asset is decreased therefore cash account is credited.	? ?	500	 500
Jan. 7	Salaries Account Cash Account (Salaries paid in cash). Explanation Increase in expense is always debit therefore salaries account is debited and cash-asset is decreased therefore cash account is credited.	? ?	200	 200
Jan. 8	Purchased Account Creditors (Moon Light) Account (Purchase goods on credit from Moon Light). Explanation Expense against purchase of goods increased therefore debited purchases account, this purchase is on credit which increases the liability therefore creditor account is credited.	? ?	6,000	 6,000
Jan. 9	Debtors (Falcons) Account Cash Account Sales Account (Sold goods on credit to Falcons and goods sold for cash) Explanation Cash-Asset increased therefore cash account is debited, goods worth Rs. 8,000 are sold on credit, this increases debtor-asset. Both cash and credit sales are increasing sales income therefore credit sales account with 12,000.	? ? ?	8,000 4,000	 12,000
Jan. 10	Cash Account Debtors (Falcons) Account (Received cash from Falcons on account). Explanation Asset-cash increased therefore debited cash account. Cash paid by debtors therefore decrease the asset-debtors therefore credit debtors account.	? ?	2,500	 2,500

Complex Accounting Entries

Accounting entries for “Discounts”

Types of discounts

A trader often allows its customers two types of discounts

- Trade discount
- Settlement discount

Trade Discount

It is the discount offered by a seller to its customers before entering into transaction with them. Trade discount is always offered based on some policy. *Examples include:*

1. Bulk purchase discounts.
2. Regular customer discounts.
3. Season end discounts.

Note:

⇒ Trade discounts are never recorded in the books of either party (Seller or Buyer). The amount after subtracting trade discount is recorded in the books of account.

For example, list price of a product is Rs.220 and retailer seller offers 10% discount to its customers. The amount after subtracting trade discount for the purpose of recording transaction in the books is:

220 – (220 x 10%) = 220 – 22 = Rs.198

Purchases Account (debit)	**Rs.198**	
Cash Account (credit)		**Rs.198**

Settlement Discount


It is the discount offered by a seller to its customers based on cash settlement terms for early payment of the invoice.

Example: Goods sold for Rs.2,000 on settlement terms (5/10, n/30). Rs. 100 shall be the amount of settlement discount (2,000 x 5%) = Rs.100. This discount is also known as cash discount.

⇒ Settlement discount is recorded in the books of both parties (Seller and Buyer).

⇒ Settlement discount for seller is known as "*discount allowed*"; and for buyer is known as "*discount received*".

Accounting Entries:

Scenario (i)

Cash received from debtor Rs.11,400 in full settlement of his account of Rs.12,000.

By analyzing this transaction, we find that there is a decrease in debtors' balance because of discount allowed to them based on settlement terms for Rs.600 and because of cash received from them Rs.11,400, therefore, the double entry would be:

		Rs.	**Rs.**
I	Cash Account	11,400	
	Debtor Account		11,400
II	Discount Allowed Account	600	
	Debtor Account		600

By combining these two journal entries, we shall have a compound entry as

(I + II)	Cash account	11,400	
	Discount Allowed Account	600	
	Debtors Account		12,000

Scenario (ii)

Cash paid to creditors Rs.9, 500 after deducting a discount of Rs.500.

By analyzing this transaction, we find that there is a decrease in creditors because of discount received from them based on settlement terms Rs.500 and because of cash paid to them for Rs.9,500. Therefore, the double entries would be:

		Rs.	**Rs.**
I	Creditor Account	9,500	
	Cash Account		9,500
II	Creditor Account	500	
	Discount Received Account		500

By combining these two journal entries we can have a compound entry as

(I + II)	Creditors Account	10,000	
	Cash Account		9500
	Discount Received Account		500

Scenario (iii)

Cash paid to Creditor in full settlement of his account Rs.9,500, after subtracting discount Rs.500.

	Rs.	**Rs.**
Creditor's Account	9,500	
Cash Account		9,000
Discount Received Account		500

Understanding the concept of settlement terms through invoice

Invoice is a document that is issued by a seller to its customer at the time of sales. An invoice states trade discount as a deduction from the list price and also states settlement terms for calculation of settlement discount in future. Following sample of invoice will explain the concept of trade discount and settlement terms:

Sample Invoice

Invoice # Date: December 19, 20X9	Business Name and Address **John Smith Traders** Customer's Name and Address **Star Traders**			
Serial No	**Description**	**Quantity**	**Rate Rs.**	**Amount Rs.**
1	Fans	5	2,000	10,000
2	Air conditioner	2	25,000	50,000
3	Room Coolers	3	10,000	30,000
	Sub Total			**90,000**
	Trade discount 10%			(9,000)
	Net amount of invoice			**81,000**
	Settlement term: 2/10, n/30			

Describing the above invoice

As per the above invoice Rs.9,000 is the amount of trade discount that is subtracted from the total amount of invoice. Net of trade discount invoice price is Rs.81,000 that is payable to the supplier on December 19, 20X9. If the invoice will be paid within 10 days i.e. by December 29, 20X9, the supplier will offer further 2% discount that is known as settlement discount (as per settlement terms given at the bottom of the invoice). Amount of settlement discount would be Rs.1,620 = (81,000 x 2%).

Accounting Entries

<u>In the Books of Seller (John Smith Traders)</u>

		Rs.	**Rs.**
Dec. 19	Debtors A/c.	81,000	
	Sales A/c.		81,000
<u>If settled before</u>			
Dec. 29	Cash A/c.	79,380	
	Discount allowed A/c.	1,620	
	Debtors A/c.		81,000
<u>If settled after</u>			
Dec. 29	Cash A/c.	81,000	
	Debtors A/c.		81,000

<u>In the Books of Buyer/Customer (Star Traders)</u>

Dec. 19	Purchases A/c.	81,000	
	Creditors A/c.		81,000
<u>If settled before</u>			
Dec. 29	Creditors A/c.	81,000	
	Cash A/c.		79,380
	Discount received A/c.		1,620
<u>If settled after</u>			
Dec. 29	Creditors A/c.	81,000	
	Cash A/c.		81,000

Practice 4.4

Pass journal entries in a journal for the following transactions during the month of December 20X9.

Dec 1: Business started with cash Rs.100,000 and furniture worth Rs.35,000 as capital.

Dec 2: Machinery purchased from Jordan on credit Rs.2,000.

Dec 4: Loan taken from bank Rs.200,000 in cash.

Dec 6: Machinery returned to Jordan Rs.2,000.

Dec 8: Bought goods on credit from Pearl Traders Rs.6,000.

Dec 10: Bought goods on credit from Giant Store for Rs.10,000 subject to a 5% trade discount.

Dec 11: Goods sold for Rs.2,000 to Falcons on settlement terms 5/10, n/30.

Dec 12: Sold goods on credit to John Smith for Rs.8,000.

Dec 16: Goods returned to Pearl Traders Rs.1,000.

Dec 17: Falcons settled his account in full.

Dec 18: Cash paid to Pearl Traders Rs.4,800 in full settlement of his account.

Dec 20: Goods returned by John smithRs.2,000.

Dec 22: Charity paid in cash Rs.200.

Dec 23: Goods worth Rs.350, Cash Rs.1,000 were taken away by the proprietor for personal use.

Dec 26: Goods distributed as free sample Rs.1,000 and given away as charity worth Rs.500.

Dec 28: Bank loan paid Rs.200,000.

Date 20X9	Particulars/Descriptions	Post Ref.	Debit (Rs.)	Credit (Rs.)
Dec 1	Cash Account Furniture Account Capital Account (Cash and Furniture introduced as capital) Explanation Two assets - cash & furniture increased therefore debited and equity is increased therefore capital account is credited.	? ? ?	100,000 35,000	 135,000
Dec 2	Machinery Account Creditors (Jordan)Account (Machinery purchased on credit from Jordan). Explanation Asset - machinery increased therefore debited, and no payment is made against the purchase therefore liability is created hence creditor account is credited.	? ?	2,000	 2,000
Dec 4	Cash Account Bank Loan Account (Loan taken in cash from Bank). Explanation Asset - cash increased therefore debited, and the cash is repayable in future therefore liability is created called loan from bank.	? ?	200,000	 200,000
Dec 6	Creditors (Jordan) Account Machinery Account (Machinery returned to Jordan). Explanation Asset - machinery decreased therefore credited, and liability is cancelled as machinery has been returned therefore liability - creditors is debited. this entry is reversal of entry on Dec. 2nd	? ?	2,000	 2,000
Dec 8	Purchase Account Creditors (Pearl Traders) Account (Bought goods on credit from Pearl Traders). Explanation Expense against purchase of goods increased therefore debited purchases account and payment is not made at time of purchase therefore liability is created by crediting creditors account.	? ?	6,000	 6,000

Dec 10	Purchases Account Creditors (Giant Store) Account (Goods purchased on trade discount of 5%) (10,000 X 95% = 9,500) Explanation Expense against purchase of goods increased therefore debited purchases account and cash-asset is decreased therefore cash account is credited. Amount will be net off of trade discount, because trade discount is not recorded.	? ?	9,500	 9,500
Dec 11	Debtor (Falcons) Account Sales Account (Goods sold on credit on settlement term 5/10, n/30) Explanation The transaction creates debtor-Asset therefore debtor account is debited and sales income increases because of sales of goods, therefore credit sales account. Discount policy is mentioned in the transaction but has no effect on sale entry.it will be accounted for at the time of receiving cash from debtor.	? ?	2,000	 2,000
Dec 12	Debtors (John Smith) Account Sales Account (Sold goods on credit to John Smith). Explanation This transaction creates debtor-Asset therefore debtor account is debited and sales income increases because of sales of goods, therefore credit sales account	? ?	8,000	 8,000
Dec 16	Creditors (Pearl Traders) Account Purchases Return Account (Goods returned to Pearl Traders). Explanation The transaction will decrease the liability payable to Pearl Traders therefore creditors account will be debited and at the same time the purchases expense is also decreasing because of goods returned to supplier therefore credit Purchase return account	? ?	1,000	 1,000
Dec 17	Cash Account Discount Account Debtor (Falcons) Account (Cash received & discount allowed) 2,000 X 5% = 100* Explanation This transaction decreases the debtor-Asset balance; therefore, debtor account is credited and cash- asset increases therefore cash account is debited. Falcon became debtor on 11th Dec. with settlement terms 5/10, n/30. Account is settled in full on 7th day on 17th Dec. Cash discount of 5% will be given because payment is made within 10 days of invoice.	? ? ?	1,900 100*	 2,000
Dec 18	Creditor (Pearl Trader) Account Cash Account Discount Received (Final settlement to Pearl Trader 6,000-1,000=5,000)	? ? ?	5,000	 4,800 200
Dec 20	Sales return Account Debtors (John Smith) Account (Goods returned by John Smith). Explanation The debtor-Asset balance decreases therefore debtor account is credited and sales income is reducing therefore debited sales return account.	? ?	2,000	 2,000

Dec 22	Charity Account Cash Account (Charity paid in cash). <u>Explanation</u> Charity increases expenses therefore charity account is debited and cash-asset is decreased therefore cash account is credited.	? ?	200	 200
Dec 23	Drawings Account Cash Account Purchases Account (Owner withdrew cash & goods for personal use). <u>Explanation</u> Whenever owner withdraws cash or goods for personal use drawing account is debited and cash-asset & stock of goods decreased therefore cash & purchases accounts are credited.	? ? ?	1,350	 1,000 350
Dec 26	Free Sampling Account Charity Account Purchases Account (Goods distributed as free sampling & given away as charity). <u>Explanation</u> Free sampling as well as charity increases expenses therefore charity and free sampling accounts are debited and stock of goods-asset is decreased therefore purchases account is credited.	? ? ?	1,000 500	 1,500
Dec 28	Bank Loan Account Cash Account (Bank Loan paid in cash) <u>Explanation</u> Liability of loan is decreased therefore debited bank loan account and cash-asset is decreased therefore cash account is credited	? ?	200,000	 200,000

Practice 4.5

Pass journal entries in a journal for the following transactions during the month of December 20X9.

Dec 1: Business started with cash Rs.200,000 out of which deposited cash into bank Rs.100,000.

Dec 2: Machinery purchased from Jordan on credit Rs.40,000

Dec 4: Machinery lost in fire accident Rs.20,000

Dec 6: Paid charity Rs.550

Dec 8: Cash withdrawal from bank Rs.5,000 for office use

Dec 10: Cash stolen from Business Rs.3,000

Dec 11: Owner sold his saving bonds of value Rs.3,000 and invested that money in business

Dec 12: Profit earned on Bank Deposits Rs.1,350

Dec 16: Received commission from a client Rs.1,000

Dec 17: Rent paid to Real Estate by cheque Rs.2,000.

Date 20X9	Particulars/Descriptions	Post Ref.	Debit (Rs)	Credit (Rs)
Dec 1	Cash Account Capital Account (Cash introduced as capital) Explanation Asset- cash increased therefore debited and equity is increased therefore capital account is credited.	? ?	200,000	 200,000
Dec 1	Bank Account Cash Account (Cash deposited into bank account) Explanation Asset- bank balance increased therefore debited bank account and asset-cash is decreased therefore cash account is credited.	? ?	100,000	 100,000
Dec 2	Machinery Account Creditors (Jordan)Account (Machinery purchased on credit from Jordan). Explanation Asset- machinery increased therefore debited and as payment has not been made so liability increased therefore creditor account is credited.	? ?	40,000	 40,000
Dec 4	Loss by Fire Account Machinery Account (Machinery lost in fire) Explanation Business losses are expenses, increase in expense is debit. Machinery-asset is decreased; therefore, machinery account is credited.	? ?	20,000	 20,000
Dec 6	Charity Account Cash Account (Cash paid as charity) Explanation Charity increases business expenses and is debited and cash-asset is decreased therefore cash account is credited.	? ?	550	 550
Dec 8	Cash Account Bank Account (Cash withdrawn from bank). Explanation Asset- cash balance increased therefore debited cash account and asset-bank balance is decreased therefore bank account is credited.	? ?	5,000	 5,000

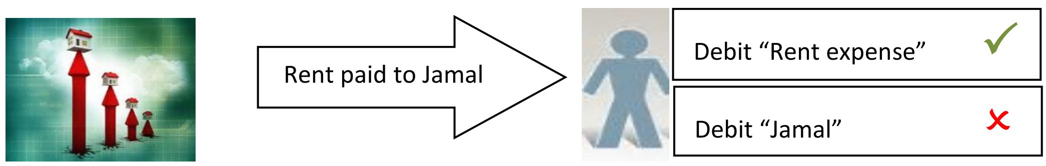
Dec 10	Loss by theft Account Cash Account (cash stolen) <u>Explanation</u> Debited loss account as an expense and asset-cash decreased therefore cash account is credited.	? ?	3,000	 3000
Dec 11	Cash Account Capital Account (Fresh capital introduced by owner) <u>Explanation</u> Asset- cash increased therefore debited and equity is increased therefore capital account is credited.	? ?	3,000	 3,000
Dec 12	Bank Account Profit on bank Account (profit earned on bank deposits). <u>Explanation</u> Asset- bank increased therefore debited and profit on bank deposits belongs to Incomes that is increasing therefore, it is credited.	? ?	350	 350
Dec 16	Cash Account Commission Account (Commission received). <u>Explanation</u> Asset- cash increased therefore debited and commission is increasing incomes of the business; therefore, commission account is credited.	? ?	1000	 1000
Dec 17	Rent Account Bank Account (Rent paid by cheque). <u>Explanation</u> Rent is increasing expenses of the business, debit the rent account and bank-asset is decreased therefore bank account is credited.	? ?	2,000	 2,000

Important Tips To Remember (ITTRs)

While analyzing expenses & incomes for recognizing accounting head as Dr or Cr, never use “*personal account”* like name of the person to whom expense is being paid or from whom income is being received, use “*nominal accounts*” as Dr or Cr.

For example:

1. Salaries paid to John, Steve and Zara; here personal account “*the names*” shall not be debited rather <u>salaries</u> as an expense account will be debited.
2. Received commission from David, Nasar, and Rajab; here personal account “*the names*” shall not be credited rather <u>commission</u> as an income account will be credited.



Subdivision of Journal

Journal is sub-divided because of complexity of the transactions or large size of business. Subdivision of journal is required when:

- There are increased number of cash transactions in a day.
- There are large number of transactions for credit purchases and credit sales.

Large number of transactions create a mess in bookkeeping office; therefore, separate bookkeepers are assigned responsibilities for separate types of transactions along with separate journals. For example:

- For sales transactions there is a ***sales journal*** in which only and only credit transaction for sales are recorded.
- For purchases transactions there is a ***purchase journal*** in which only and only credit transactions for purchases are recorded.
- If there are a large number of returns then separate ***journals for sales return*** *and* ***purchases return*** are also maintained.
- For cash transactions there is a separate book in which only cash transactions are analyzed and recorded it is named as ***cash book or cash journal or cash register***.
- All remaining transactions and events like sale and purchase of fixed assets on credit, loss by fire etc. are recorded in ***general journal****.* General journal is also used to record *rectifying entries, adjusting entries and closing entries*.

SALES JOURNAL

Need for Sales Journal

In small business entities there are very less number of transactions for credit sales. As we can have an example of a barber's shop, a tailor, a retailer etc. they mostly sell their services or goods on cash. But as business expands, its sales also grow in terms of cash as well as in terms of credit. The cash sales are then recorded in the cash book as a receipt, and the credit sales are recorded in a separate journal named as sales journal (sales day book). In sales journal, no other transactions are recorded except the transactions for sales on **credit terms.**

✓ Credit sales
✗ Cash sales

Recording transactions in Sales Journal

In case of credit sales, the business is always interested in the names and addresses of its credit customers (Debtors), therefore, sales journal is designed accordingly in order to cover following information:

Date---------------------- Date of invoice

Name of Debtor ------- Mentioned in the invoice

Invoice number ------- It helps to trace the other details of invoice

Post reference --------- Page number of subsidiary ledger

Amount of invoice ---- Net of trade discount

Format of Sales Journal

Date	Name of Debtors	Invoice No.	Post. Ref.	Amount Rs.

In the sales journal, there is only one column for amount because all transactions are of same nature (credit sales) and the purpose of maintaining sales journal is to avoid over working for recording the debits and credits for each transaction again & again. After specific intervals (a week or a month), sum of sales journal is posted to the debit of "*total debtors account"* and credit of "*sales account"* in general ledger (details will be discussed later).

Practice 4.5

Record following transactions in a Sales Journal.

Feb 1: Credit sales to Nelson Rs.3,875

Feb 3: Credit sales to John Smith Rs.1,667

Feb 6: Credit sales to Moon Light Rs.1,285

Feb 10: Credit sales to Super Mart Rs.550

Feb 17: Credit sales to Moon Light Rs.9,280

Feb 19: Credit sales to Popular Traders Rs.2,880

Feb 27: Credit sales to Pearl Traders Rs.8,250

Feb 28: Credit sales to Royal Club Rs.4,244

Sales Journal

Date 20X9	**Name of Debtors**	**Invoice No.**	**Post. Ref.**	**Amount Rs.**
Feb 1:	Nelson			3,875
Feb 3:	John Smith			1,667
Feb 6:	Moon Light			1,285
Feb 10:	Super Mart			550
Feb 17:	Moon Light			9,280
Feb 19:	Popular traders			2,880
Feb 27:	Pearl Traders			8,250
Feb 28:	Royal club			4,244
Feb 28:	**Total**			**32,031**

PURCHASE JOURNAL

Need for Purchase Journal

After knowing the need of sales journal (as discussed in previous section) it is now very easy to understand that for large business entities, which use to deal with so many transactions for credit purchases on daily basis, it becomes necessary to maintain a separate book for recording transactions of purchases on credit terms. This book is named as purchase journal. Obviously, same like a sales journal, no cash transaction for purchase shall be recorded in this book.

✓ Credit purchases
× Cash purchases

Recording transactions in Purchase Journal

The basic content of a purchase journal is exactly the same as in the case of a sales journal with the exception of Name of Creditors instead of Debtors.

Format of Purchases Journal

Date	Name of Creditors	Invoice No.	Post. Ref.	Amount Rs

Purchase journal shows a list of all credit purchases in a stipulated time period. Credit purchases recorded in purchase journal, during a period, are summed up and their debit effect is given to "*purchases account*" and credit effect is given to "*total creditors account*" in general ledger (details will be discussed later).

Practice 4.6

Record following transactions in a Purchase Journal.

Feb 1: Purchase on credit from Shahla Rs.2,875

Feb 3: Purchase on credit from Samrana Rs.667

Feb 6: Purchase on credit from Amara Rs.285

Feb 10: Purchase on credit from Fareeha Rs.550

Feb 17: Purchase on credit from Saima Rs.8,280

Feb 19: Purchase on credit from Arooj Rs.1,880

Feb 27: Purchase on credit from Naila Rs.7,250

Feb 28: Purchase on credit from Shumaila Rs.3,244

Date 20X9	**Name of Creditor**	**Invoice No.**	**Post. Ref.**	**Amount Rs.**
Feb 1:	Shahla			2,875
Feb 3:	Samrana			667
Feb 6:	Amara			285
Feb 10:	Fareeha			550
Feb 17:	Saima			8,280
Feb 19:	Arooj			1,880
Feb 27:	Naila			7,250
Feb 28:	Shumaila			3,244
Feb 28:	**Total**			**25,031**

SALES RETURN JOURNAL *(RETURN INWARDS JOURNAL)*

Need for Sales Return Journal

As the business expands the number of complaints and return inwards also increases. Such return inwards can be recorded in the sales journal as a negative entry if these are very few in number. But because of its contra nature it is recommended to maintain a separate journal for sales return. However, in sales return journal only the returns against credit sales (from Debtors) are recorded. Returns of cash sales are not recorded in this journal.

Goods sold on credit - returned by customers

Recording transaction in sales return Journal

Same like sales journal a sales return journal also contains the same content. It is used to record credit transactions of return inwards during a stipulated time period. At the closing date of the period sum of the sales return journal is debited to the "*sales return account"* and credited to the "*debtors account"*.

Practice 4.7

Enter the following transactions in a sales return journal.

Feb. 1: Goods returned by Madinah Stores Rs.200
Feb. 9: Goods returned by John SmithRs.100
Feb. 10: Goods returned by Giant Store Rs.300
Feb. 11: Goods returned by Falcons Rs.400
Feb. 16: Goods returned by Pearl Traders Rs.50
Feb. 19: Goods returned by Nelson Rs.150
Feb. 23: Goods returned by Mega Mart Rs.500
Feb. 28: Return inwards by Giant store Rs.600

Date	Name of Debtors	Credit Note No.	Post Ref.	Amount Rs.
Feb. 1	Madinah Stores			200
Feb. 9	John Smith			100
Feb. 10	Giant Store			300
Feb. 11	Falcons			400
Feb. 16	Pearl Traders			50
Feb. 19	Nelson			150
Feb. 23	Mega Mart			500
Feb. 28	Giant Store			600
	Total			**2,300**

PURCHASES RETURN JOURNAL *(RETURN OUTWARDS JOURNAL)*

Need for Purchases Return Journal

Although purchases return can be recorded in the purchase journal as negative entry but same like sales return journal it is required to maintain a separate journal for purchases return because of its contra in nature to the purchases. Purchases return journal is maintained to record credit transactions for purchases return.

Goods purchased on credit - returned to suppliers

Recording transactions in Purchases Return Journal

All transactions for purchases return are recorded chronologically in the purchases return journal. The sum of purchases return journal is debited to the "*creditors account"* and credited to the "*purchases return account"*.

Practice 4.8

Enter the following transactions in a Purchases Return Journal

Feb. 1: Goods returned to Mega Mart Rs.200
Feb. 3: Goods returned to Royal club Rs.600
Feb. 7: Goods returned to Super Mart Rs.120
Feb. 9: Goods returned to Moon Light Rs.300
Feb. 11: Goods returned to Star Gold Rs.500
Feb. 15: Goods returned to Hills Bros. Rs.550
Feb. 19: Goods returned to Dunhill mart Rs.600
Feb. 23: Return outwards to Falcons Rs.800

Date 20X9	Name of Creditors	Credit Note No.	Post Ref.	Amount Rs.
Feb. 1	Mega Mart			200
Feb.3	Royal Club			600
Feb. 7	Super Mart			120
Feb. 9	Moon Light			300
Feb. 11	Star Gold			500
Feb. 15	Hills Bros.			550
Feb. 19	Dunhill mart			600
Feb. 23	Falcons			800
Feb. 28	**Total**			**3,670**

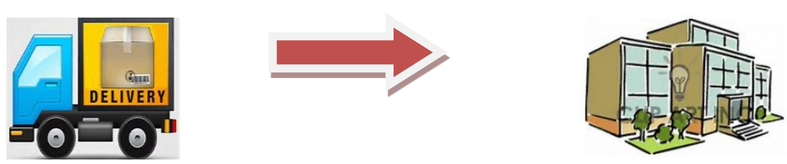
Practice 4.9

Record following transactions in the appropriate journals.

Dec 2:	Credit sales to Nelson Rs.600, John smithRs.200, Hills Bros. Rs.500
Dec 4:	Credit purchases from Giant store Rs.450, Star Gold Rs.300, Moon Light Rs.250
Dec 5:	Credit sales to Madinah Stores Rs.630, John smithRs.500, Falcons Rs.420
Dec 6:	Credit purchase from Falcons Rs.1,000
Dec 10:	Goods returned by Nelson Rs.100, John smithRs.50
Dec 12:	Goods returned to Star Gold Rs.80, Giant store Rs.30
Dec 18:	Credit sales to Super Mart Rs.650
Dec 24:	Return outwards to Falcons Rs.200
Dec 28:	Return inwards from Super Mart Rs.150

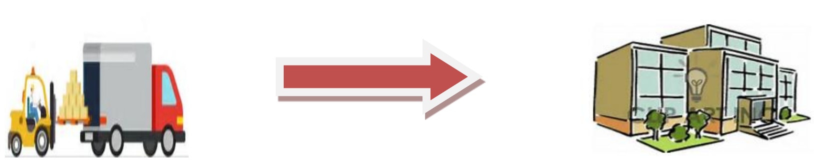
Sales Journal

Date 2003	Name of Debtors	Invoice No.	Post. Ref.	Amount Rs.
Dec 2	Nelson			600
	John Smith			200
	Hills Bros.			500
Dec 5	Madinah stores			630
	John Smith			500
	Falcons			420
Dec 18	Super Mart			650



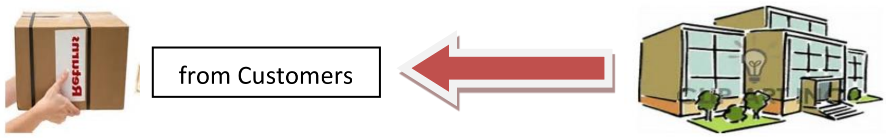
Purchases Journal

Date 2003	Name of Creditors	Invoice No.	Post. Ref.	Amount Rs.
Dec 4	Giant Store			450
	Star Gold			300
	Moon Light			250
Dec 6	Falcons			1,000



Sales Return Journal

Date	Name of Debtors	Credit Note No.	Post Ref.	Amount Rs.
Dec. 10	Nelson			100
	John Smith			50
Dec. 28	Super Mart			150



Purchase Return Journal

Date	Name of Creditors	Credit Note No.	Post Ref.	Amount Rs.
Dec. 12	Star Gold			80
	Giant store			30
Dec. 24	Falcons			200

CASH BOOK

Need for Cash Book

Cash book is a book of original entries in which only cash transactions are recorded in a chronological sequence. The journal (book of original entry) is subdivided for two types of transactions i.e. credit transactions and cash transactions. All credit transactions are recorded in various relevant journals, as discussed above, whereas the cash transactions are recorded in a separate book named as cash book.

Recording transactions in Cash Book

A cash book is divided into two sections, one for cash receipts and the other for cash payments. Each section is formatted for *date, particulars, post reference* and *amount*.

As a matter of fact; within a cash book, we maintain two cash journals; 1) *cash receipt journal* and 2) *cash payment journal*. Cash book is formatted like a ledger account (T shaped). Thus, it also serves as a book of secondary entry (details will be discussed later).

Types of Cash Book

1. Single column cash-book (with cash column only)
2. Two column cash-book (with cash and bank columns) OR (with cash and discount columns) OR (with bank and discount columns)
3. Three column cash-book (with cash, bank and discount columns)
4. Petty cash book (multi columnar cash book for recording insignificant nature of expenses)

Cash Book (Single Column)

Date	RECEIPTS Particulars	Post Ref.	Amount Rs.	Date	PAYMENTS Particulars	Post Ref.	Amount Rs.

Cash Book (Two Columns)

Date	RECEIPTS Particulars	P/R	Cash Rs.	Bank Rs.	Date	PAYMENTS Particulars	P/R	Cash Rs.	Bank Rs.

Cash Book (Three Columns)

Date	RECEIPTS Particulars	Discount allowed	Cash Rs.	Bank Rs.	Date	PAYMENTS Particulars	Discount Received	Cash Rs.	Bank Rs.

Petty Cash Book

Date	Receipts Rs.	Particulars	Total Payments Rs.	Enter-tainment Rs.	Photo copy Rs.	Repair Rs.	Travelling Rs.	Postage Rs.	Misc. Rs.

Practice 4.10

Record following transactions into a cash book with single cash column and find closing balance to carry forward.

		Rs.
Mar. 1:	Balance brought forward (b/f)	4,000
Mar. 3:	Sold goods for cash	40,000
Mar. 7:	Sold goods on credit to Alpha (credit transaction)	75,000
Mar. 10:	Bought goods for cash	28,000
Mar. 15:	Bought goods on credit from Beta (credit transaction)	42,000
Mar. 18:	Received cash from Debtor (Alpha)	75,000
Mar. 19:	Made part payment in cash to Creditor (Beta)	15,000
Mar. 20:	Paid staff salaries	20,000
Mar. 26:	Bought furniture for cash	25,000
Mar. 30	Paid Electricity bill	5,000

Cash Book

Date 20X9	RECEIPTS Particulars	Post Ref.	Rs.	Date 20X9	PAYMENTS Particulars	Post Ref.	Rs.
March 1	**Balance b/f**		**4,000**	March 10	Purchases		28,000
3	Sales		40,000	19	Creditor (Beta)		15,000
18	Debtor (Alpha)		75,000	20	Staff salaries		20,000
				26	Furniture		25,000
				30	Electricity bill		5,000
				31	**Balance c/f**		**26,000**
			119,000				**119,000**

Practice 4.11

Record following transactions into a cash book with cash and bank columns, also find closing balance for both columns to carry forward.

20X9

Mar. 1: Balances brought forward cash Rs.7,000; bank Rs.25,000

Mar. 2: Sold goods for cash Rs.40,000, the amount was deposited into bank on the same date.

Mar. 5: Bought stationary for cash Rs.2,000

Mar. 9 Bought furniture, payment made by cheque Rs.10,000

Mar. 15: Received Rs.15,000 in cash from Debtor Sagheer

Mar. 16: Received a cheque of Rs.20,000 from Debtor Kabeer and deposited into bank

Mar. 20: Made payment to a creditor Abeer through cheque Rs.18,000

Mar. 22: Cash withdrawn from bank for office use Rs.25,000

Mar. 25: Cash withdrawn from Bank from owner's personal use Rs.8,000

Mar. 28: Cash received from sale of old machine Rs.60,000

Mar. 30 Cash deposited into bank Rs.75,000 and paid salaries in cash Rs.20,000

Cash book

Date **20X9**	Receipts Particulars	Post Ref.	Cash Rs.	Bank Rs.	Date **20X9**	Payments Particulars	Post Ref.	Cash Rs.	Bank Rs.
Mar. 1	**Balance b/f**		**7,000**	**25,000**	Mar. 05	Stationery		2,000	
2	Sales			40,000	09	Furniture			10,000
15	Debtor - Sagheer		15,000		20	Creditor - Abeer			18,000
16	Debtor - Kabeer			20,000	22	Cash	C		25,000
22	Bank	C	25,000		25	Drawings			8,000
28	Machine (Disposal)		60,000		30	Bank	C	75,000	
30	Cash	C		75,000	30	Salaries		20,000	
					31	**Balance c/f**		**10,000**	**99,000**
			107,000	**160,000**				**107,000**	**160,000**

Practice 4.12

Record following transactions into three column cash-book; with cash, bank, and discount columns, also find closing balances to carry forward.

20X9

Mar. 1: Balance brought forward: Cash Rs.3,000; Bank overdraft Rs.10,000

Mar. 5: Cash received from debtor Burhan in full settlement of his account balance Rs.50,000, after subtracting 8% cash discount.

Mar. 10: Received a cheque of Rs.70,000 from debtor Affan in full settlement of his account after subtracting cash discount Rs.5,000.

Mar. 15: Goods sold on credit to debtor Aman worth Rs.80,000 subject to settlement terms 5/10, n/30 and a trade discount of Rs.4,000. (credit transaction – no effect in cash book)

Mar. 20: Paid Rs.40,000 through cheque to creditor Arslan after subtracting cash discount Rs.4,000.

Mar. 25: Paid to Salman his account balance due Rs.25,000 in cash after subtracting cash discount Rs.2,000.

Mar. 30: Received cheque from debtor Aman against sales made on **March 15th** and deposited into bank.

Mar. 31 Cash in excess of Rs.6,000 is to be deposited into bank. (Rs.6,000 should remain in cash balance c/f)

Cash book

Date **20X9**	Receipts Particulars	P-Ref	Cash **Rs.**	Bank **Rs.**	Disc. Allowed **Rs.**	Date **20X9**	Payments Particulars	P-Ref	Cash **Rs.**	Bank **Rs.**	Disc. Received **Rs.**
Mar. 1	**Balance b/f**		**3,000**			Mar. 01	**Balance b/f**			**10,000**	
5	Debtor – Burhan		46,000		4,000	20	Creditor - Arslan			40,000	4,000
10	Debtor - Affan			70,000	5,000	25	Creditor - Salman		23,000		2,000
30	Debtor - Aman			76,000		31	Bank	C	20,000		
31	Cash	C		20,000		31	**Balance c/f**		**6,000**	**116,000**	
			49,000	**166,000**	**9,000**				**49,000**	**166,000**	**6,000**

Petty Cash Book

Transactions that are recorded in petty cash book are insignificant (petty) in nature and amount for which substantial documentation is not required. For example; photocopy, entertainment, postage, local travelling, cleaning material, etc.

Accountants do separately recognize *cash at bank*, *cash in hand* and *petty cash* that can be distinguish as:

1. Main Cash (for significant receipts and payments)
2. Petty Cash (for insignificant payments)

Mechanism to maintain Petty Cash Book

Normally an existing staff member, in addition to his/her regular duties, is delegated with additional responsibility of *patty cashier* to handle petty cash transactions. Some amount of money, depending upon the need of the organization, is transferred from main cash to petty cash from which the petty cashier meets petty expenses. There are two systems existing for transfer of money from main cash to petty cash:

1. Petty Cash System
2. Imprest System

Petty Cash System

Under the petty cash system, a fixed sum of money is transferred to petty cash on a regular interval to meet petty expenses in that period. In a way a petty cashier receives a fixed amount at the start of each week to meet petty expenses during that week.

For example; In the first week of business setup the petty cashier receives Rs.1,000 and spends Rs.970 for different petty expenses and left with a balance of Rs.30 in petty cash box. In the start of second week; the petty cashier once again receives Rs.1,000 from the main cash and keeps it in the petty cash box that increases the balance of petty cash box, on that day, to Rs.1,030. During the second week the petty cashier spends Rs.990. Now the balance in petty cash box, at the end of second week, is Rs.40. In the start of third week the petty cashier once again receives Rs.1,000 from the main cash book and keeps it in the petty cash box that increases the balance in petty cash box to Rs.1,040.

Imprest System

Under the imprest system, maximum need of cash for petty expenses in a specific time period is fixed. Funds are transferred to petty cashier for making payment of petty expenses during the period. The balance left in the petty cash box at the end of that period is then *topped-up* to reach at the pre-determined maximum limit. In a way the amount topped-up is exactly equal to the amount spent during the previous period for petty expenses. This is considered to be a very standard way of controlling petty expenses.
For example; a petty cashier receives Rs.1,000 at the start of first week to meet petty expenses during that week on imprest system. The petty cashier spends Rs.970 for different petty expenses and left with a balance of Rs.30 in petty cash box. In the start of second week; the petty cashier receives Rs.970 from the main cash in order to top-up petty cash box balance up to Rs.1,000. During the second week the petty cashier spends Rs.990. Now the balance in petty cash box, at the end of second week, is Rs.10 and the amount for top-up is Rs.990 to make the balance in petty cash box equal to Rs.1,000.

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Practice 4.13

Record following transactions in petty cash book for the week at imprest system. Maximum limit is Rs.1,000.

Date	Transactions	Rs.
Jan 01	Funds transferred from main cash for petty expenses	1,000
Jan 01	Paid for tea bags	150
Jan 02	Paid for cycle repair	200
Jan 03	Paid for photocopies	50
Jan 03	Paid for cycle stand at bank	10
Jan 03	Paid for postage	60
Jan 05	Paid for sugar and tea biscuits	220
Jan 06	Paid for stove repair	180
Jan 07	Paid for stationery	120

Petty Cash Book

Date	Receipt Rs.	Particulars	Total Payment Rs.	Enter-tainment Rs.	Photo copy Rs.	Repair Rs.	Travelling Rs.	Postage Rs.	Stationery Rs.
Jan 01	1,000	Imprest Main Cash							
Jan 01		Tea bags	150	150					
Jan 02		Cycle repair	200			200			
Jan 03		Photocopy	50		50				
Jan 03		Cycle stand	10				10		
Jan 03		Postage	60					60	
Jan 05		Sugar etc.	220	220					
Jan 06		Stove repair	180			180			
Jan 07		Stationery	120						120
		Balance c/f	10						
	1,000	**Total**	**1,000**	**370**	**50**	**380**	**10**	**60**	**120**
Jan 08	10	Balance b/f							
Jan 08	990	Imprest Main Cash							

Exercise Questions

Choose correct answer

1. Goods purchased from John smith Rs.500 are debited to _____

a. John smith account
b. Goods Account
c. Cash Account
d. **Purchases Account**

Explanation: whenever goods are purchased, business expenses for purchasing increases. Therefore, purchases account will be debited.

2. Commission paid to agent Jordan Rs.1,000 will be debited to _____

a. **Commission account**
b. Cash Account
c. Jordan Account
d. None of above

Explanation: Payment for commission to agent increases business expenses. Therefore, commission account will be debited.

3. Goods purchased for Rs.5,000 subject to 10% trade discount, amount to be debited to purchases account will be _____

a. 5,000
b. 5,500
c. **4,500**
d. None of the above

Explanation: Trade discount is subtracted from the total amount of purchases and then the transaction is recorded with net off the discount amount. 5000 x 10% = 500 therefore, purchases account will be 5,000 – 500 = 4, 500

4. Goods returned from debtors will be recorded in which book of account?

a. **Return inward journal**
b. Return outward journal
c. Purchase journal
d. General journal

Explanation: Goods returned from debtor will be recorded in return inward journal (also called sales return journal)

5. Payment received from Star Brothers Rs.4,800 in full settlement of Rs.5,000 will be debited to _____

a. Cash Account
b. Discount allowed Account
c. Star Brothers Account
d. **Both a. and b.**

Explanation: Increase in cash-asset Rs.4,800 is debited to Cash Account and loss Rs.200 in terms of settlement discount will be debited to Discount Allowed Account.

6. Loan repaid to Hassan Brothers will be debited to _____

a. Hassan Brothers
b. **Hassan Brothers' Loan Account**
c. Cash Account
d. None of above

Explanation: Repayment means the loan taken in the past is being returned now. This transaction causes a decrease in existing liability therefore debited Hassan Brothers' Loan account. Debiting simply Hassan Brothers will create a confusion as if loan is being advanced to Hassan Brothers.

7. Goods purchased for cash will be recorded in which book of account?

a. Purchase journal
b. **Cash book**
c. General journal
d. a and b both

Explanation: All cash transactions are recorded in cash book. Purchase journal is used to maintain record of credit purchases only.

8. Machinery purchased from on credit from Caterpillar will be recorded in which book of account?

a. Assets journal
b. Purchases journal
c. **General journal**
d. Machinery journal

Explanation: Purchase journal is maintained for regular purchases of trading goods and raw material that has second effect on trade creditors. Purchase of fixed assets is not a regular purchase therefore shall not be recorded in purchase journal. General journal is the book in which this transaction is recorded.

9. Stock lost in fire will be credited to _____
a. Stock account
b. Goods Account
c. **purchases Account**
d. Loss by fire Account

Explanation: Whenever purchased goods are decreased other than because of sales or purchases return; purchases account will be credited.

10. Short explanation written below the accounting entry is called _____
a. Explanation
b. **Narration**
c. Compound entry
d. None of above

Explanation: Narration is a terminology that is used for the explanatory statement written beneath the accounting entry and becomes integral part of it.

Answer: (1-d, 2-a, 3-c, 4-a, 5-d, 6-b, 7-b, 8-c, 9-c, 10-b)

Examination Questions

Q.1

The correct double entry to record goods returned from a credit customer is

	Dr	Cr
a)	Returns outwards	Receivables
b)	Receivables	Returns outwards
c)	Receivables	Returns inwards
d)	**Returns inwards**	**Receivables**

Q.2

Which of the following is correct?

	Dr balances include:	Cr balances include:
a)	**Returns inwards** **Discounts allowed** **Carriage inwards**	**Capital** **Sales** **Bank overdraft**
b)	Returns outwards Discounts allowed Carriage outwards	Capital Sales Bank loan
c)	Returns inwards Discounts received Purchases	Sales Returns outwards Accrued income
b)	Returns outwards Cash Land and buildings	Capital Returns inwards Accrued income

Q.3

Ali's business has a bank overdraft balance of Rs.190

What is the balance on Ali's Bank column of in three column cash-book after the following transactions?

1. Ali paid off his account balance of Rs.600 to a supplier after taking advantage of 3% settlement discount.
2. Rs.780 was received from a customer. They had already subtracted 2.5% cash discount.

a) Rs.388 Dr
b) Rs.8 Dr
c) Rs.11.50 Dr
d) Rs.368.50 Dr

Explanation to Q.3

Cr. Balance Overdraft	**Rs. 190**
Cr. Payment to Supplier	**Rs. 582 (600x97%)**
Dr. Receipt from Customer	**Rs. 780**
Dr. Balance	**Rs. 8**

Chapter – 5

Main Ledger / General Ledger / Nominal Ledger
(Book of secondary entries)
and
Trial Balance

Sr. No	Course outline Topics
1	Need for ledger
2	Chart of Accounts
3	Format of ledger account
4	Posting from General Journal into Main Ledger - Practice
5	Posting of Compound Entries into Main Ledger
6	Practice – Posting Process
7	Balancing the ledger accounts
8	Balancing the ledger accounts - Practice
9	Trial Balance
10	Posting from subdivided journal into main ledger
11	Posting from cash book into main ledger

Topic videos 47-57 are mandatory part of this module

MAIN LEDGER / GENERAL LEDGER / NOMINAL LEDGER

Need for a Ledger

A journal in itself is a chronological record of all the financial information (economic phenomena) but this doesn't reflect the information that is required for preparation of reports. In order to generate reports, for example; Balance Sheet, we need balance (total amount) of Assets, Liabilities, and Owners' Equity.

Example Company
Balance Sheet
December 31, 2016

ASSETS	
Current assets	
Cash	$ 2,100
Petty cash	100
Temporary investments	10,000
Accounts receivable - net	40,500
Inventory	31,000
Supplies	3,800
Prepaid insurance	1,500
Total current assets	89,000
Investments	36,000
Property, plant & equipment	
Land	5,500
Land improvements	6,500
Buildings	180,000
Equipment	201,000
Less: accum depreciation	(56,000)
Prop, plant & equip - net	337,000
Intangible assets	
Goodwill	105,000
Trade names	200,000
Total intangible assets	305,000
Other assets	3,000
Total assets	$ 770,000

LIABILITIES	
Current liabilities	
Notes payable	$ 5,000
Accounts payable	35,900
Wages payable	8,500
Interest payable	2,900
Taxes payable	6,100
Warranty liability	1,100
Unearned revenues	1,500
Total current liabilities	61,000
Long-term liabilities	
Notes payable	20,000
Bonds payable	400,000
Total long-term liabilities	420,000
Total liabilities	481,000
STOCKHOLDERS' EQUITY	
Common stock	110,000
Retained earnings	220,000
Accum other comprehensive income	9,000
Less: Treasury stock	(50,000)
Total stockholders' equity	289,000
Total liabilities & stockholders' equity	$ 770,000

Journals or books of original entries do not produce final balances of all accounting heads, for this purpose we need to prepare summary of each accounting head in a systematic way with the help of records maintained in journals. Such summaries are known as *ledger accounts* and the book in which these are prepared is knows as a *Main Ledger or General Ledger or Nominal Ledger.*

Journal ⟶ ***Ledger***

Chart of accounts

Chart of *accounts* is a list of the names of *accounts* that business accountant identifies from the journal and prepares for recording transactions in its general ledger. A company has the flexibility to tailor its *chart of accounts* to best suit to its needs, including adding *accounts* as needed.

Preparation of Chart of Accounts

There are number of accounting heads recognized as debit (Dr) and credit (Cr) in journal. In order to prepare a summary of all these accounting heads, the first step is to extract a list of all the accounting heads existing in a journal. Such list of accounting heads is known as chart of accounts. In a chart of accounts, a unique number is allocated to each accounting head which helps a bookkeeper, as well as user of financial information, to identify the accounting heads.

Chart of Accounts – Example 1

Chart of Accounts			
Number	**Description**	**Account Type**	**Financial Statement**
1-001	Cash	Asset	Balance Sheet
1-010	Accounts Receivable	Asset	Balance Sheet
1-020	Prepaid Expenses	Asset	Balance Sheet
1-030	Inventory	Asset	Balance Sheet
1-040	Fixed Assets	Asset	Balance Sheet
1-050	Accumulated Depreciation	Asset	Balance Sheet
1-060	Other Assets	Asset	Balance Sheet
2-001	Accounts Payable	Liability	Balance Sheet
2-010	Accrued Liabilities	Liability	Balance Sheet
2-020	Taxes Payable	Liability	Balance Sheet
2-030	Payroll Payable	Liability	Balance Sheet
2-040	Notes Payable	Liability	Balance Sheet
3-001	Common Stock	Equity	Balance Sheet
3-010	Retained Earnings	Equity	Balance Sheet
3-020	Additional Paid in Capital	Equity	Balance Sheet
4-001	Revenue	Revenue	Income Statement
4-010	Sales returns and allowances	Revenue	Income Statement
5-001	Cost of Goods Sold	Expense	Income Statement
5-010	Advertising Expense	Expense	Income Statement
5-020	Bank Fees	Expense	Income Statement
5-030	Depreciation Expense	Expense	Income Statement
5-040	Payroll Tax Expense	Expense	Income Statement
5-050	Rent Expense	Expense	Income Statement
5-060	Supplies Expense	Expense	Income Statement
5-070	Utilities Expense	Expense	Income Statement

Chart of Account – Example 2

1. Assets

11 Cash

12 Accounts Receivable

14 Stocks

15 Prepaid Insurance

17 Land

18 Office Equipment

2. Liabilities

21 Accounts payable
23 Rent Payable (accrued)

3. Owner's equity

31 Owner's capital
32 Owner's drawings

4. Incomes

41 Sales
42 Sales return

5. Expenses

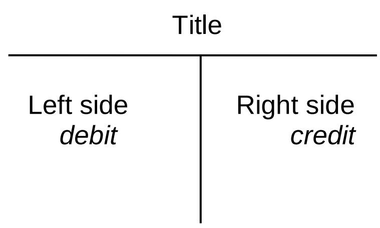
51 Wages
52 Rent
54 Utilities
55 Stationery
59 Office maintenance

Format of ledger accounts

A ledger account, in its simplest form, has three parts

- *First*, each account has a title, which is the name of accounting head.
- *Second*, each account has a debit side, which is its left-hand side.
- *Third*, each account has a credit side, which is its right-hand side.

The account format presented below is called **T account** because it resembles the letter T of English language alphabets.



Amounts entered on the left side of an account are called **debits** to the account. When amounts are entered in the debit side of an account, the account is said to be debited (or charged) with a specific amount.

Amounts entered on the right side of an account are called **credits** to the account, the account is said to be credited with a specific amount when amounts are entered in the credit of an account.

Comprehensive format of a ledger account

A ledger account with full details is prepared in two styles:

a) T account style (traditional approach)

b) Running balance style (modern approach)

(a) T account style

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.

(b) Running balance style

Date	Particulars	Post Ref.	Debit Rs.	Credit Rs.	Dr/Cr	Balance Rs.

The T account style ledger accounts are balanced off on closing date of the accounting period.

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Whereas, the running balance style ledger accounts produce balances continuously throughout the accounting period i.e. after each Dr/Cr posting.

Posting from General Journal

The process of picking up amount from journal and placing into the debit or credit side of relevant ledger account in ledger is known as *posting*. This process of posting is executed very technically by following the principles of double entry book keeping.

Following section will illustrate the process of posting from journal into ledger.

Entry A

On January 1, 2009 owner introduced cash Rs.25,000 as capital into the business.

Journal **Page 01**

Date 2009	Particulars	Post Ref	Rs.	Rs.
Jan.1	Cash account Capital account (Cash introduced as capital in the business)	L61 L08	25,000	 25,000

To start posting process of the above journal entry, we have to prepare two ledger accounts in the ledger i.e. *cash* account and *owner's capital* account.

The effect of this transaction is shown in the ledger accounts by transferring the amount and date of the journal entry to the left (debit) side of the *cash* and to the right (credit) side of *owner's capital*. It is shown as:

Cash Account **Page 61**

Date 20X9	Particulars	Post Ref.	Rs	Date 2009	Particulars	Post Ref.	Rs
Jan 1	Capital account	J01	25,000				

Owner's Capital Account **Page 08**

Date 2009	Particulars	Post Ref.	Rs	Date 2009	Particulars	Post Ref.	Rs
				Jan 1	Cash account	J01	25,000

Important Tips to Remember (ITTRs)

1. Accounting head in journal entry opposite to the ledger accounts shall be written as a *reason* in the particulars column. In the debit side of cash account, the reason is written as *capital account* and in the credit side of the capital account the reason is written as *cash account* (as shown above).

2. We can interpret this posting by reading the two ledger accounts as: On Jan.1, 2009 cash account is debited with Rs.25,000 because of the capital account and capital account is credited with Rs.25,000 because of the cash account.

Entry B

On January 5, the owner bought Computer for Rs.8,000, paying cash.

Journal **Page 2**

Date 20X9	Particulars	Post Ref.	Rs.	Rs.
Jan.5	Computer account Cash account (Purchase computer for business)	L10 L61	8,000	 8,000

The posting of this entry is shown in relevant ledgers accounts as follows:

Cash Account **Page 61**

Date	Particulars	Post Ref.	Rs	Date 20X9	Particulars	Post Ref.	Rs
				Jan 5	Computer account	J02	8,000

Computer Account **Page 10**

Date 20X9	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan5	Cash account	J02	8,000				

Entry C

On January 10, the owner purchased goods on credit from Pasha worth Rs.1,500.

Journal **Page 03**

Date 20X9	**Particulars**	**Post Ref.**	**Rs.**	**Rs.**
Jan.10	Purchases account Creditor (Pasha) account (Purchased goods on credit)	L13 L42	1,500	 1,500

The posting of this entry is shown in the relevant ledger account as follows:

Purchases Account **Page 13**

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 10	Creditors account	J03	1,500				

Creditors (Pasha) Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
				Jan 10	Purchases account	J03	1,500

Entry D

On January 18, received cash of Rs.2,500 from customers for sale of goods.

Page 04

Date 20X9	Particulars	Post Ref.	Rs.	Rs.
Jan.18	Cash account	L61	2,500	
	Sales account	L24		2,500
	(sold goods for cash)			

Cash Account **Page 61**

Date 20X9	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 18	Sales account	J04	2,500				

Sales Account **Page 24**

Date	Particulars	Post Ref.	Rs	Date 20X9	Particulars	Post Ref.	Rs
				Jan 18	Cash account	J04	2,500

Entry E

On January 30, the owner paid creditors on account, Rs.1,000.

Page 05

Date 20X9	Particulars	Post Ref.	Rs.	Rs.
Jan.30	Creditors	L42	1,000	
	Cash	L61		1,000
	(Paid creditors on account)			

The posting of this entry is shown in the relevant ledger account as follows:

Cash Account **Page 61**

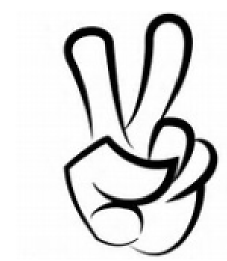
Date	Particulars	Post Ref.	Rs	Date 2009	Particulars	Post Ref.	Rs
				Jan 30	Creditors	J05	1,000

Creditors Account **Page 42**

Date 2009	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 30	Cash account	J05	1,000				

Important Tips to Remember (ITTRs)

Each journal entry is posted twice in the ledger. One, in the debit side of the ledger account and second in the credit side of another ledger account with the same amount. This is because of double entry book keeping system.



Entry F (Compound entry)

On January 1, 20X9 owner introduced cash Rs.25,000 and a computer worth Rs.10,000 into the business as capital.

Journal **Page 01**

Date 20x9	Particulars	Post Ref	Rs.	Rs.
Jan.1	Cash account	L61	25,000	
	Computer account	L12	10,000	
	Capital account	L08		35,000
	(Cash and computer introduced as capital in the business)			

Cash Account **Page 61**

Date 20X9	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
Jan 1	Capital account	J01	25,000				

Computer Account **Page 12**

Date 20X9	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
Jan 1	Capital account	J01	10,000				

Owners Capital Account **Page 08**

Date	Particulars	Post Ref.	Rs.	Date 20X9	Particulars	Post Ref.	Rs.
				Jan 1	Cash account	J01	25,000
				Jan 1	Computer account	J01	10,000

Post Reference

In the post reference column of journal, the page number of the ledger is written in which its effect was posted. In the same way, as a cross reference in the post reference column of a ledger account, the page number of journal is written from which this entry was posted in the ledger.

In journal the post reference column is also named as 'ledger folio (LF)' and in ledger the post reference column is also named as 'journal folio (JF)'.

Journal **Page 01**

Date 2009	Particulars	Post Ref	Rs.	Rs.
Jan.1	Cash account Capital account (Cash introduced as capital in the business)	L61 L08	25,000	 25,000

Cash Account **Page 61**

Date 20X9	Particulars	Post Ref.	Rs	Date 2009	Particulars	Post Ref.	Rs
Jan 1	Capital account	J01	25,000				

Owner's Capital Account **Page 08**

Date 2009	Particulars	Post Ref.	Rs	Date 2009	Particulars	Post Ref.	Rs
				Jan 1	Cash account	J01	25,000

Practice 5.1

Jan 1 Started business with Rs.200,000 in the bank and Rs.40,000 in cash
Jan 1 Bought shop fittings Rs.40,000 and a van Rs.60,000. Both paid by cheque.
Jan 2 Paid rent expense by cheque Rs.5,000.
Jan 3 Bought goods, for reselling, on credit from Jordan & Co. Rs.50,000
Jan 5 Cash sales Rs.5,000.
Jan 8 Paid wages of assistant in cash Rs.1,000.
Jan 10 Paid insurance expense by cheque Rs.500.
Jan 12 Cash sales Rs.8,000.
Jan 15 Paid wages of assistant in cash Rs.1,000.
Jan 17 Paid Jordan & Co. Rs.30,000 by cheque and goods returned to Jordan & Co.Rs.6,000.
Jan 19 Bought goods, for reselling, on credit from Dunhill & Co. Rs.25,000.
Jan 19 Cash sales Rs.7,000.
Jan 22 Paid wages of assistant in cash Rs.1,000.
Jan 24 Bought stationery and paid in cash Rs.500.
Jan 25 Cash sales Rs.15,000.
Jan 27 Paid Dunhill & Co. Rs.14,000 by cheque.
Jan 29 Paid wages of an assistant in cash Rs.1,000.
Jan 31 Deposited cash Rs.20,000 into the bank.

Required: *Journalize the above transactions and prepare ledger accounts*

Date 20X9	Particulars	Post Ref.	Debit (Rs)	Credit (Rs)
Jan. 1	Bank Account Cash Account Capital Account (Capital introduced by the owner).	? ?	200,000 40,000	 240,000
Jan. 1	Furniture & Fittings Account Van Account Bank Account (Purchase of furniture & fittings and van for the business).	? ?	40,000 60,000	 100,000
Jan. 2	Rent Account Bank Account (Rent paid by cheque).	? ?	5,000	 5,000
Jan. 3	Purchases Account Creditors (Jordan & co.) (Purchase goods on credit).	? ?	50,000	 50,000
Jan. 5	Cash Account Sales Account (Goods sold for cash).	? ?	5,000	 5,000
Jan. 8	Wages Account Cash Account (Wages paid in cash).	? ?	1,000	 1,000
Jan. 10	Insurance Account Bank Account (Insurance paid by cheque).	? ?	500	 500
Jan. 12	Cash Account Sales Account (Goods sold for cash).	? ?	8,000	 8,000
Jan. 15	Wages Account Cash Account (Wages paid in cash).	? ?	1,000	 1,000
Jan. 17	Creditor (Jordan & co.) Return outwards Account (Goods returned to Jordan & co.).	? ?	6,000	 6,000
Jan. 17	Creditor (Jordan & co.) Account Bank Account (Paid Jordan & co. by cheque).		30,000	 30,000

Jan. 19	Purchases Account Creditor (Dunhill) Account (Bought goods on credit).	? ?	25,000	 25,000
Jan. 19	Cash Account Sales Account (Sold goods for cash).	? ?	7,000	 7,000
Jan. 22	Wages Account Cash Account (Paid wages for cash).	? ?	1,000	 1,000
Jan. 24	Stationery Account Cash Account (Stationery purchased for cash).	? ?	500	 500
Jan. 25	Cash Account Sales Account (Goods sold for cash).	? ?	15,000	 15,000
Jan. 27	Creditor (Dunhill & Co) Account Bank Account (Paid to creditors by cheque).	? ?	14,000	 14,000
Jan. 29	Wages Account Cash Account (Wages paid in cash).	? ?	1,000	 1,000
Jan. 31	Bank Account Cash Account (Cash paid into bank).	? ?	20,000	 20,000

Chart of Accounts

Following is the chart of accounts for above journal;

1. Capital account
2. Cash account
3. Bank account
4. Furniture & fittings account
5. Van account
6. Rent account
7. Purchases account
8. Creditor (Dunhill & Co) account
9. Creditor (Jordan & Co) account
10. Sales account
11. Wages account
12. Insurance account
13. Purchases Return account
14. Stationery account

Bank Account

Date 2009	Particulars	Post Ref.	Rs	Date 2009	Particulars	Post Ref.	Rs
Jan 1	Capital Account		200,000	Jan 1	Furniture & Fittings A/c		40,000
Jan 31	Cash Account		20,000	Jan 1	Van Account		60,000
				Jan 2	Rent Account		5,000
				Jan 10	Insurance Account		500
				Jan 17	Jordan & co. Account		30,000
				Jan 27	Dunhill & Co. Account		14,000

Cash Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan.1	Capital Account		40,000	Jan.8	Wages Account		1,000
Jan.5	Sales Account		5,000	Jan.15	Wages Account		1,000
Jan.12	Sales Account		8,000	Jan.22	Wages Account		1,000
Jan.19	Sales Account		7,000	Jan.24	Stationery Account		500
Jan.25	Sales Account		15,000	Jan.29	Wages Account		1,000
				Jan.31	Bank Account		20,000

Capital Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
				Jan. 1	Bank Account		200,000
				Jan. 1	Cash Account		40,000

Furniture & Fittings Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 1	Bank Account		40,000				

Van Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 1	Bank Account		60,000				

Rent Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 2	Bank Accounts		5,000				

Purchases Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 3	Jordan & co. Account		50,000				
Jan. 19	Dunhill & Co. Account		25,000				

Creditor (Jordan & Co) Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 17	Purchases Return A/c		6,000	Jan 31	Purchases A/c		50,000
Jan 17	Bank Account		30,000				

Sales Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
				Jan 5	Cash Account		5,000
				Jan 12	Cash Account		8,000
				Jan 19	Cash Account		7,000
				Jan 25	Cash Account		15,000

Wages Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 8	Cash Account		1,000				
Jan 15	Cash Account		1,000				
Jan 22	Cash Account		1,000				
Jan 29	Cash Account		1,000				

Insurance Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 10	Bank Account		500				

Purchases Return Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
				Jan 17	Jordan & co. A/c		6,000

Creditor (Dunhill & Co) Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 27	Bank Account		14,000	Jan 19	Purchases A/c		25,000

Stationery Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs

Jan 18	Cash Account		500				

Balancing the ledger accounts

Ledger accounts are used to summarize all financial information about one accounting head in one place and these are also prepared to extract the final balance of that summary/account.

In the above **practice 5.1,** the ledger accounts are not producing final balances (which can be reported in the financial statements), rather we are having so many amounts posted in the debit side and so many amounts posted in the credit side of a ledger account. *So, now we need to balance each ledger account*.

Balancing figure is an amount that equalizes both sides of a ledger account. Supposedly, sum of the debit side of a ledger account is Rs.15,000 and sum of the credit side of the same ledger account is Rs.9,000 then its balancing figure would be Rs.6,000 and will be written in the credit side to equalize both; debit & credit sides.

Sample Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 18	Cash Account		5,000	Jan 25	Cash		9,000
Jan 20	Cash Account		7,000				
Jan 30	Cash Account		3,000		**Balancing figure**	**ß**	**6,000**
Total			**15,000**		**Total**		**15,000**

Debit Total **Credit Total** **Debit Balance**
Rs.15,000 – Rs.9,000 = Rs.6,000

Let's find out the balance of "Bank account" prepared in the **practice 5.1**;

Step 1. Total of Debit side Rs.220,000.
Step 2. Total of Credit side Rs.149,500.
Step 3. Deduct the sum of lower side out of the sum of higher side; the Balance is Rs.70,500.

The balance either Debit/Credit, depends on the heavier side. In this case total sum of debit side is greater than the total sum of credit side. Therefore, Rs.70,500 will be called as debit balance.

Bank Account

Date 1997	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 1	Capital Account		200,000	Jan 1	Furniture & Fittings A/c		40,000
Jan 31	Cash Account		20,000	Jan1	Van Account		60,000
				Jan2	Rent Account		5,000
				Jan 10	Insurance Account		500
				Jan 17	Jordan & co. Account		30,000
				Jan 27	Dunhill & Co. Account		14,000
				Jan 31	***Balance***	**ß**	***70,500***
	Total		**220,000**		**Total**		**220,000**

Identifying the Balance

A balancing figure appearing in the credit side of a ledger account is known as a *Debit Balance* and a balancing figure appearing in the debit side of a ledger account is known as *Credit Balance*.

Mechanism of Balancing Ledger Account

The accounting head, which is required to be balanced should be linked with its group's nature, that will be either Dr/Cr, the side of its group's nature is its *'natural side'* and it would always produce greater sum, the sum of other side (means the lower side) is then subtracted from the sum of natural side to ascertain balancing figure.

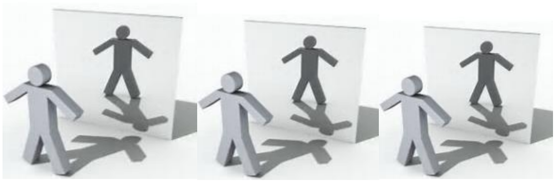
For example, cash account is an accounting head of ASSET and its group is Dr therefore its debit side is its natural side and would usually be greater in total than its Cr side.

In order to balance a ledger account following steps should be followed precisely:

1. Identify "natural side" of the accounting head.
2. Make total of the "natural side" (being greater).
3. Place this sum at the bottom of both sides (Dr. and Cr.) of the ledger account.
4. Deduct, one by one, the amounts of lower side (opposite to the natural side) from the total of the "natural side" (that has already been placed at the bottom).
5. Place the balancing figure in the lower side, so that the sum of both sides remains same.

There is an exception to the above criterion, that's for contra nature of accounts e.g. sales return account and purchases return account etc. This happens because the natural side (greater side) of contra accounts would always be opposite to the group's nature.

Contra Accounts



Contra accounts are the accounting heads, which are presented in financial reports as deduction from the original accounting heads. For example;

Original Accounts	**Contra Accounts**	**Main Head/Group**
Purchases	Purchases returns	Expense
Sales	Sales return	Income
Capital	Drawings	Owner's Equity
Fixed Asset	Provision for depreciation *(will be discussed later)*	Asset
Debtors	Provision for bad debts *(will be discussed later)*	Asset

Although the main head of contra account remains the same as to its original accounting head but the contra account behaves oppositely, therefore, its balance is always opposite to the balance of its original accounts.

Practice 5.2

Work out balances of the above ledger accounts prepared in **practice 5.1**

Bank Account

Date 1997	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 1	Capital Account		200,000	Jan 1	Furniture & Fittings A/c		40,000
Jan 31	Cash Account		20,000	Jan 1	Van Account		60,000
				Jan 2	Rent Account		5,000
				Jan 10	Insurance Account		500
				Jan 17	Jordan & co. Account		30,000
				Jan 27	Dunhill & Co. Account		14,000
				Jan 31	*Balance*	ß	*70,500*
			220,000				**220,000**

Cash Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 1	Capital Account		40,000	Jan 8	Wages Account		1,000
Jan 5	Sales Account		5,000	Jan 15	Wages Account		1,000
Jan 12	Sales Account		8,000	Jan 22	Wages Account		1,000
Jan 19	Sales Account		7,000	Jan 24	Stationery Account		500
Jan 25	Sales Account		15,000	Jan 29	Wages Account		1,000
				Jan 31	Bank Account		20,000
				Jan 31	*Balance*	ß	*50,500*
			75,000				**75,000**

Capital Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 18	*Balance*	ß	*240,000*	Jan 1	Bank Account		200,000
				Jan 1	Cash Account		40,000
			240,000				**240,000**

Furniture & Fittings Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 1	Bank Account		40,000	Jan 31	*Balance*	ß	*40,000*
			40,000				**40,000**

Van Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 1	Bank Account		60,000		*Balance*	ß	*60,000*
			60,000				**60,000**

Rent Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 2	Bank Accounts		5,000	Jan 31	*Balance*	ß	*5,000*
			5,000				**5,000**

Purchases Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 3	Jordan & co. A/c		50,000	Jan 31	*Balance*	ß	*75,000*
Jan 19	Dunhill & Co. A/c		25,000				
			75,000				**75,000**

Creditor (Jordan & Co.) Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 17	Purchases Return A/c		6,000	Jan 31	Purchases A/c		50,000
Jan 17	Bank Account		30,000				
Jan 31	*Balance*	ß	*14,000*				
			50,000				**50,000**

Sales Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 31	*Balance*	ß	*35,000*	Jan 5	Cash Account		5,000
				Jan 12	Cash Account		8,000
				Jan 19	Cash Account		7,000
				Jan 25	Cash Account		15,000
			35,000				**35,000**

Wages Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 8	Cash Account		1,000	Jan 31	*Balance*	ß	*4,000*
Jan 15	Cash Account		1,000				
Jan 22	Cash Account		1,000				
Jan 29	Cash Account		1,000				
			4,000				**4,000**

Insurance Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 10	Bank Account		500	Jan 31	*Balance*	ß	*500*
			500				**500**

Purchases Return Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 31	*Balance*	ß	*6,000*	Jan 17	Jordan & Co. A/c		6,000
			6,000				**6,000**

Creditor (Dunhill & Co.) Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 27	Bank Account		14,000	Jan 19	Purchases A/c		25,000
Jan 31	*Balance*	ß	*11,000*				
			25,000				**25,000**

Stationery Account

Date	Particulars	Post Ref.	Rs	Date	Particulars	Post Ref.	Rs
Jan 18	Cash Account		500	Jan 31	*Balance*	ß	*500*
			500				**500**

Trial Balance

Trial balance is merely a list of balances extracted from the ledger containing final balance of each ledger account. In a trial balance; all accounting heads having debit balances are plotted at the left-hand side (Dr-side) and likewise all accounting heads having credit balances are plotted at the right-hand side (Cr-side).

Following is the trial balance of the ledger accounts prepared in preceding **practice 5.2**

Sr. No.	Particulars	Debit Rs.	Credit Rs.
1	Bank account	70,500	
2	Cash account	50,500	
3	Capital account		240,000
4	Furniture & fittings account	40,000	
5	Van account	60,000	
6	Rent account	5,000	
7	Purchases account	75,000	
8	Creditor Jordan & Co. account		14,000
9	Sales account		35,000
10	Wages account	4,000	
11	Insurance account	500	
12	Return outwards account		6,000
13	Creditor Dunhill & Co. account		11,000
14	Stationery account	500	
	Total	**306,000**	**306,000**

The sole purpose of preparing a trial balance is to know all ledger balances in one sheet. It is also said that trial balance is a check of arithmetic accuracy of bookkeeping. The sum of debit balances appearing in the trial balance should always be equal to the sum of credit balances appearing in it. If there is some arithmetic error (transposition of figure or wrong casting of figures etc.), the trial balance will show a difference. It is true that trial balance is an indicator of arithmetic accuracy not the accuracy of bookkeeping.

A trial balance cannot indicate errors of the book-keeping. For example; i) omission of a complete transaction for recording, ii) giving Dr or Cr effect to wrong accounting head, iii) passing correct journal entry with wrong amount etc. Types of errors and their rectification will be discussed in a separate chapter.

Posting from sub-divided journals

Journals are sub-divided when a business enters into number of credit transactions relating to purchases & sales and also when a separate cash book is required to record large number of cash transactions. The mechanism of posting process from subdivided journals into the relevant ledger accounts is somewhat different from the posting process discussed earlier (i.e. from general journal into ledger).

Posting from purchase journal into main ledger

Credit transactions of purchases are recorded in purchases journal. In the presence of a purchase journal all credit transactions of purchases are not recorded in the general journal therefore, these would have remained un-posted in the ledger had we ignored posting from purchase journal.

The posting process from a purchase journal is very simple and easy. As the purchase journal is totaled periodically, (weekly, fortnightly or monthly) only its periodic balance is posted into the relevant ledger accounts. The sum of purchases journal is posted into the debit (Left) side of the "*Purchases Account"* and into the credit (Right) side of the "*Sundry/Total Creditors Account"*.

Practice 5.3

PURCHASE JOURNAL

Date 2009	Name of Creditor	Inv. No.	Post. Ref.	Amount Rs.
Feb 1	Mian			2,875
Feb 3	Malik			667
Feb 6	Butt			285
Feb 10	Jutt			550
Feb 17	Buttar			8,280
Feb 19	Mughal			1,880
Feb 27	Kashmiri			7,250
Feb 28	Meer			3,244
Feb 28	**Total**			**25,031**

Sundry/Total Creditors Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
Feb 28				Feb 28	Purchases Account		25,031

Purchases Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
Feb 28	Creditors Account		25,031	Feb 28			

Posting from sales journal into main ledger

The process of posting from sales journal is similar to the process we discussed for posting from purchase journal. Here in the case of sales journal the two accounting heads are: 1) sales account and 2) sundry/total debtors account. All transactions recorded in the sales journal are of similar nature therefore, only the sum of sales journal is posted in the credit side of "*Sales Account"* and the debit side of "*Sundry/Total Debtors Account"*.

Practice 5.4

SALES JOURNAL

Date 2009	**Name of Debtors**	**Invoice No.**	**Post. Ref.**	**Amount Rs.**
Mar2	Tiwana			5,425
Mar6	Kumboh			928
Mar10	Dar			728
Mar14	Tiwana			1,872
Mar18	Bhatti			5,427
Mar22	Kumboh			271
Mar28	Sial			9,494
Mar30	Rajpoot			899
Mar31	**Total**			**25,044**

Sales Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
				Mar 31	Debtors Account		25,044

Sundry/Total Debtors Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
	Sales Account		25,044				

Posting from cash book into main ledger

Posting of second effects of receipts and payments into the other relevant ledger accounts is done as follows:

Practice 5.5

Cash Book

Date	Receipts	Post Ref.	Rs.	Date	Payments	Post Ref.	Rs.
	Capital A/c		20,000		Rent A/c		500
	Debtors A/c		5,000		Creditors A/c		4,000
	Commission A/c		2,000		Stationery A/c		1,000
	Sales A/c		10,000		Purchases a/c		8,000
					Balance	ß	23,500
			37,000				**37,000**

Capital Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
	Balance	ß	20,000		Cash A/c		20,000

Sundry Debtors Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
	Sales journal		25,044		Cash A/c		5,000
					Balance	ß	20,044

Commission Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
	Balance	ß	2,000		Cash A/c		2,000

Sales Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
					Cash A/c		10,000
	Balance	ß	35,044		Sales journal		25,044

Rent Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
	Cash A/c		500		Balance	ß	500

Sundry Creditors Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
	Cash A/c		4,000		Purchase journal		25,031
	Balance	ß	21,031				

Stationery Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
	Cash A/c		1,000		Balance	ß	1,000

Purchases Account

Date	Particulars	Post Ref.	Rs.	Date	Particulars	Post Ref.	Rs.
	Cash A/c		8,000				
	Purchase journal		25,031		Balance	ß	33,031

Trial Balance

Heads of Accounts	Debit Rs.	Credit Rs.
Cash account	23,500	
Capital account		20,000
Sundry/total debtors account	20,044	
Commission account		2,000
Sales account		35,044
Rent account	500	
Sundry/total creditors account		21,013
Stationary account	1,000	
Purchases account	33,031	
	78,075	78,075

<u>Important Tips To Remember (ITTRs)</u>

1. Although cash book is not a part of main ledger but its balance is put into the trial balance.
2. If cash book is maintained then cash account is not prepared in main ledger.
3. Balance appearing in Dr. side of a ledger account is known as Cr. balance and balance appearing in Cr. side of a ledger account is known as Dr. balance.
4. All Dr. Balances are placed in debit side of Trial Balance and all Cr. Balances are placed in credit side of Trial Balance.
5. In order to balance a ledger account; firstly, make total of the heavier side and then subtract the amounts appearing in lower side of the ledger account.
6. The side matching with nature of the relevant ledger account would always be heavier. e.g. Cr. Side of creditors account would always be heavier than its Dr. side and should be totaled first.
7. Never put c/d or c/f (carry down/forward) with balances of the revenue/nominal nature of accounts (income and expense) because balances of these accounts are closed into the Income Statement of current reporting period and are never ever carried forward in next reporting period.
8. Trial balance is not a part of Financial Statements. It is merely a list of balances that shows arithmetical accuracy of book-keeping. It is prepared only and only to make oneself satisfied that all Dr. entries have been reciprocated with equal amount of Cr. entries.
9. In this chapter we discussed postings into the main ledger for the purpose of preparing trial balance. Detailed postings from sales and purchases journals into the individual ledger accounts (subsidiary ledger) will be discussed in the upcoming chapter i.e. control accounts.

Exercise Question

State whether each of following statements is True or False

1. Ledger keeps transactions in chronological order.
2. Posting is done in Ledger.
3. Ledger is a source for preparation of Trial Balance.
4. An account will show a debit balance if its credit side is greater than its debit side.
5. First of all, the transactions are recorded in ledger.
6. Cash Account always shows a debit balance.
7. Debit side of expenses is always greater than its credit side.
8. While posting from general journal to ledger; the opposite account will be used to show as reference in particulars column of ledger account.

Answer: 1-False, 2-True, 3-True, 4-False, 5-False, 6-True, 7-True, 8-True

Explanation:

1. In journal, entries are recorded in chronological order.
2. True
3. True
4. When credit side is greater than the debit side; balance will be called as credit balance.
5. Transactions are recorded in journal first.
6. True
7. True
8. True

Exercise Question

Q. 1

The following are the transactions of Kiran's business during her first month of trading.

Record each transaction in T-accounts.

1. Kiran starts a business and pays in Rs.5,000 as capital
2. The business buys a car for Rs.1,000 cash
3. They buy goods for resale for Rs.500 cash
4. They buy more goods for resale for Rs.600 on credit from Mr Ali
5. They pay rent of Rs.200 cash
6. They sell half the goods for Rs.800 cash
7. They sell the remaining goods on credit for Rs.900 to Miss Zara
8. They pay Rs.400 cash on account of the amount owing to Mr Ali
9. They receive Rs.500 from Miss Zara
10. Kiran withdraws Rs.100 cash from the business

Answer to Q. 1

Capital a/c

		Cash	5,000

Receivables a/c

Sales	900	Cash	500
		Balance	400
	900		900
Balance	400		

Sales a/c

		Cash	800
		Receivables	900
Balance	1,700		
	1,700		1,700
		Balance	1,700

Payables a/c

Cash	400	Purchases	600
Balance	200		
	600		600
		Balance	200

Purchases a/c

Cash	500		
Payables	600		
		Balance	1,100
	1,100		1,100
Balance	1,100		

Car a/c

Cash	1,000		

Rent a/c

Cash	200		

Withdrawals a/c

Cash	100		

Cash a/c

Capital	5,000	Car	1,000
Sales	800	Purchases	500
Receivables	500	Rent	200
		Payables	400
		Withdrawals	100
		Balance	4,100
	6,300		6,300
Balance	4,100		

CHAPTER – 6

Preparation of Financial Statements

Sr. No	Course Outline Topics
1	Components of Financial Statements and Accounting Equations
2	Proper format of Income Statement
3	Proper format of Balance Sheet
4	Practice

Topic videos 58-61 are mandatory part of this module

Components of financial statements

Although a trial balance reveals the amounts of final balances of each accounting head (chart of accounts) appearing in the main ledger, but one cannot construct an opinion about the profitability or financial strength of the entity with the help of trial balance alone. To achieve this objective an accountant has to prepare some financial statements that include:

1. Income statement (Statement of profit or loss and other comprehensive income)
2. Balance sheet (Statement of financial position)

(According to International Accounting Standard (IAS) 1, there are five components of financial statements; 1) Statement of Financial Position 2) Statement of Profit or Loss and Other Comprehensive Income 3) Statement of Cash Flows 4) Statement of Changes in equity and 5) Notes to the Financial Statements, but at initial stage only two components i.e. Statement of Profit or Loss and Other Comprehensive Income (commonly known as Income Statement) and Statement of Financial Position (commonly known as Balance Sheet) are discussed, rest of the components will be discussed later.

Income statement (Statement of Profit or Loss and Other Comprehensive Income) is prepared to know the financial performance of an entity. Financial performance refers to the profitability (profit or loss) of entity during the year. This is prepared with the help of all balances relating to incomes & expenses appearing in the trial balance. Income statement is prepared for a specific period for which starting and ending dates are defined, normally a year, that is known as *reporting period*.

Remember this equation:	**Incomes – Expenses = Profit**	***Equation 6.1***

Balance sheet (Statement of Financial Position) is prepared to know the financial position of an entity. Financial position refers to the financial strength of entity on a specific date. Normally it is prepared as on closing date of the accounting year, which is known as *reporting date* of the reporting period. Financial strength of the entity is known through the sum of total asset (resources) of the entity and the sum of total financial sources required to finance these assets i.e. owners' equity and liabilities (sources).

Remember this equation:	**Assets = Owners equity + Liabilities**	***Equation 6.2***

Equations 6.1 & 6.2 provide the basic ideology of income statement and balance sheet respectively. In actual practice the income statement and balance sheet are not prepared in equation style. The detailed formal format of these statements will be discussed later. For now, we shall do a little practice to identify the items to be shown in the income statement and balance sheet.

Practice 6.1

Prepare income statement and balance sheet with the help of following trail balance.

Accounting heads	Debit Rs.	Credit Rs.
Bad debts	305	
Advertisement	1,506	
Telephone Bill	1,615	
Stationery	500	
Repairs	600	
Sales Revenue		40,600
Purchases Expense	28,500	
Salaries and wages	4,850	
Machinery	12,500	
Creditor		5,250
Debtors	7,810	
Furniture	5,600	
Land	28,000	
Drawings	7,218	
Rent Income		1,000
Capital		52,154
Total	**99,004**	**99,004**

Closing stock valued at Rs. 9,960

Income Statement for the reporting period…

Income		-	Expense		=	Net Profit
Sales Revenue	40,600		Purchases Expense	28,500		
Rent income	1,000		Less: closing Stock*	(9,960)		
			Cost of goods sold	18,540		
			Bad debts	305		
			Advertisement	1,506		
			Telephone bill	1,615		
			Stationery	500		
			Repairs	600		
			Salaries & wages	4,850		
	41,600	-		**27,916**	=	**13,684**

Balance Sheet as on the reporting date…

Assets		=	Owner's equity		+	liabilities	
Debtor	7,810		Capital	52,154		Creditors	5,250
Stock closing*	9,960		Add Net profit	13,684			
Furniture	5,600		Less Drawings	(7,218)			
Machinery	12,500						
Land	28,000						
				58,620	+		5,250
	63,870	=				**63,870**	

*The cost that expires during the reporting year is reported as expense. Cost of closing stock is un-expired cost and its economic benefit shall flow to the entity in future. Closing stock represents the unsold purchased goods. Therefore, this is subtracted from the purchases (expenses) and included in the list of assets.

Proper Format of Income Statement and Balance Sheet

Entity's Name
Income Statement
For the year ended 31 December 20X9

	Rs.	Rs.
Sales Revenue		***
Cost of Goods Sold *(Note 1)*		
Opening stock	***	
Purchases	***	
Closing stock	(***)	(***)
Gross Profit *(Note 2)*		***
Operating Expenses *(Note 3)*		(***)
Operating Profit		***
Other Income *(Note 4)*		***
Net Profit *(Note 5)*		***

Entity's Name
Balance Sheet
As at 31 December 20X9

		Rs.	Rs.
Assets			
	Fixed Assets (Note 6)		
	Land	***	
	Building	***	
	Machinery	***	
	Furniture	***	***
	Current Assets (Note 7)		
	Stock / Inventory	***	
	Debtors	***	
	Bank balance	***	
	Cash in hand	***	***
			***
Owner's Equity *(Note 8)*			
	Capital	***	
Add:	Net profit	***	
Less:	Drawings	(***)	***
Liabilities:			
	Long term loans *(Note 9)*		
	Loan from bank	***	
	Finance lease liability	***	***
	Current liabilities *(Note 10)*		
	Creditors	***	
	Bank overdraft	***	
	Short term loans	***	***
			***

Notes:

1 Cost of Goods Sold

Although the purchases account is an accounting head that belongs to the main head EXPENSES and should be straightaway subtracted from sales account to ascertain gross profit of the entity, but all the goods purchased are rarely sold out in the year of purchase. Some of the goods purchased might remain unsold on the closing date of the reporting period, therefore such unsold goods (closing stock) is deducted from the purchases to calculate the figure of cost of those goods that have been sold during the period (cost of goods sold). In-fact it is the cost which has expired during the period to earn sales income and the portion not yet expired is closing stock which shall be shown in the balance sheet as an ASSET.

The closing stock of the previous reporting period becomes opening stock for the current reporting period and its sales become part of current reporting period's income, therefore the opening stock is included in the current reporting period's cost of goods sold as an EXPENSE.

2 Gross Profit

Income statement is divided into two portions, first portion ends at Gross Profit. Gross profit shows potential of the entity to meet operating expenses during the period. That the goods were sold at a reasonable margin and this margin (gross profit) is available to meet operating expenses i.e. administrative, selling and distribution expenses of the same reporting period.

3 Operating Expenses

These are the expenses which are incurred to run/operate the entity. These include;

1. Administrative expenses
2. Selling, distribution and marketing expenses

A business cannot even think to sell its goods or services without incurring operating expenses. These operating expenses are deducted from the gross profit to ascertain operating profit of the business.

3.1 Administration Expenses

These are routine expenses of the entity that are incurred to run the administrative affairs. These include but not restricted to; staff salaries, building rent, repairs, insurance, electricity bill, water & gas bill, telephone bill, stationery, entertainment etc.

3.2 Selling, Distribution and Marketing Expenses

It is clear from its name that these expenses are incurred to promote the sales, these include but not restricted to; sales staff wages and commission, advertisement, free sampling, carriage outwards, discount allowed, bad debts etc.

4 Other Incomes

These are the non-operating incomes. These are the earnings, which are not generated through the principal activities of the entity, rather these are the earnings through the sources other than sales of goods or services. These include but not restricted to; rent income, interest income, commission income, discount received etc.

5 Net Profit

As discussed earlier, the income statement is split into two portions; the first portion shows gross profit and the second portion shows net profit. In-fact, it is the profit that management of the entity wants to know through income statement in order to take certain economic decisions.

6 Fixed Assets

These are the assets that are held; for use in production of goods/services or delivery of goods/services, for renting to others and for administration purpose. These normally provide economic benefits to the entity for more than one accounting year.

7 Current Assets

These are the assets that are held for trading purposes (means stock for selling purpose) and/or are expected to be recovered in cash in next twelve months (debtor), and/or are cash in hand and cash at bank.

8 Owners' Equity

It is the wealth of owners held by the entity. It includes the amount of capital (personal resources of the owners invested into the entity) and also the net profit earned/generated by the entity by utilizing owner's capital. The amount of drawings is subtracted from it as these were the entity's resources distributed to the owners against the expected profit of the entity.

9 Long-Term Loan

It is an obligation on the entity that is expected to be settled after more than one accounting year. It is the source of finance that is obtained from lenders (financial institutions).

10 Current Liabilities

These are obligations on the entity that are payable within next twelve months. These include but not restricted to; creditors, bank overdraft and current portion of the long-term loans payable within next twelve months.

Practice 6.1 – Answer

Entity's Name
Income Statement
For the year ended 31st December 20X9

	Rs.	Rs.
Sale		40,600
Cost of Goods Sold ***(Note 1)***		
Opening stock	-	
Purchases	28,500	
Closing stock	(9,960)	(18,540)
Gross Profit		22,060
Operating Expenses:		
Bad Debts	305	
Advertisement	1,506	
Telephone Bill	1,615	
Stationary	500	
Repairs	600	
Salaries & Wages	4,850	9,376
Operating Profit/Income		12,684
Other Income		
Add: Rent Income		1,000
Net Profit/Income		**13,684**

Entity's Name
Balance Sheet
As at 31 December 20X9

	Rs.	Rs.
Assets		
Fixed Assets		
Land	28,000	
Machinery	12,500	
Furniture	5,600	46,100
Current Assets		
Stock	9,960	
Debtors	7,810	17,770
		63,870
Owner's Equity		
Capital	52,154	
Add: Net Profit	13,684	
Loss: Drawings	(7,218)	58,620
Liabilities		
Current liabilities		
Creditors		5,250
		63,870

Exercise Question

Q.1

Esme started in business on 1 January 20X6, by investing Rs.150,000 as capital.

Esme took Rs.100 per week from the business to cover living expenses (drawings), other than for 2 weeks in August when she took RS.500 per week.

At 31 December 20X6, the assets and liabilities of the business were as follows:

	Rs.
Building	45,000
Furniture	75,000
Trade Debtors	2,300
Trade Creditors	10,000
Stock in trade	17,900
Loan payable	500
Cash at bank	1,300

Prepare Balance Sheet of Esme and calculate profit or loss made during the year.

Answer

Assets		**=**	**Owner's equity**		**+**	**liabilities**	
Building	45,000		Capital	150,000		Creditors	10,000
Furniture	75,000		**Less Net Loss***	**(13,000)**		Loan	500
Stock	17,900		Less Drawings	(6,000)			
Debtors	2,300						
Cash at Bank	1,300						
				131,000	+		10,500
	141,500	=				**141,500**	

***Net Loss is a Balancing Figure**

Q. 2
A business has opening inventory of Rs.7,200 and closing inventory of Rs.8,100. Purchases for the year were Rs.76,500, carriage inward was Rs.50 and carriage outward was Rs.180.

What is the amount of cost of sales?

a) Rs.75,550
b) **Rs.75,650**
c) Rs.75,830
d) Rs.77,450

Answer
Opening inventory
Add Purchases
Add Carriage inwards
Less Closing inventory

Q. 3
Javed had the following assets and liabilities at the beginning and end of his financial year:

	Beginning of the year	End of year
	Rs.	Rs.
Trade payables	18,000	22,000
Inventories	24,000	27,500
Long-term borrowings	15,000	10,000
Property plant and equipment	82,000	86,500
Cash and cash equivalents	2,500	1,500

During the year, Javed withdrew Rs.11,500 in drawings and no capital was introduced.

How much profit did Javed make for the year?

R

Hint: prepare opening and closing balance sheets to calculate owner's equity balances and then prepare equation "Op OE + Profit – Drawings = Cl OE

Examination Questions

1. **Alia sold some items of inventory for Rs.1,950 in cash, which she had purchased for Rs.2,622. How are her assets and owner's equity affected by this transaction of sale?**

	Assets	Owner's Equity
A.	reduced by Rs.672	reduced by Rs.672
B.	reduced by Rs.2,622	reduced by Rs.672
C.	increased by Rs.672	increased by Rs.2,622
D.	increased by Rs.1,950	reduced by Rs.672

Explanation: It's a loss-making transaction that is reducing inventory by Rs. 2,622 and increasing cash asset by Rs. 1,950

2. **The profit earned by a business in 20X7 was Rs.72,500. The proprietor brought in new capital of Rs.8,000 during the year and withdrew goods for his private use, which had cost Rs.2,200.**

If owner's equity at the beginning of the period were Rs.101,700, what was the closing owner's equity?

A. Rs.35,000
B. Rs.39,400
C. Rs.168,400
D. Rs.180,000

Explanation: Opening OE 101,700+Fresh Cap 8,000 + Profit 72,500 – Drawings 2,200 = 180,000

3. Hala has set up a new business. The following balances are recorded in her books:

Owner's equity	Rs.5,000
Bank overdraft	Rs.10,000
Motor car	Rs.6,000

Her only other asset is office furniture. She has no other liabilities.

What is book value of her office furniture?

Rs

Explanation: Owners equity 5,000 + Bank OD 10,000 – Motor car 6,000 = Office furniture 9,000

CHAPTER - 7

BANK RECONCILIATION STATEMENT (BRS)

Sr. No	Course Outline Topics
1	Basic Concepts of Bank Reconciliation
2	Nature and Behaviour of Balances
3	Possible reasons of differences - Those need adjustment in cash book
4	Possible reasons of differences - Those need to be presented in BRS
5	Practice - Given: Both Balances
6	Practice - Given: Previous BRS, current cash book and current bank statement
7	Practice - Given: Previous cash book and current bank statement
8	BRS – Accounting Entries

Topic 062 – 068 are included in this chapter.

Basic concept of Bank Reconciliation

It is a professional responsibility of an accountant to keep cash book balances updated in conformity with the balances as per the record maintained by bankers.

Both entities i.e., *Business* (as a bank account holder) and *Bank* (in which business funds are kept), maintain proper books of accounts to record transactions between business and the bank. These transactions mainly include; deposit of money in the bank and withdrawal of money from the bank.

Accountant of the business, who maintains cash book, prepares a bank reconciliation statement on a specific date, normally at the end of each month.

In this statement the reasons causing difference among the *balance as per cash book* and *balance as per bank statement* are presented. These reasons arise because of timing difference, whereas for some reasons adjustments are required to be made by bankers in their records.

Sometimes, while tracking transactions in the bank statement; accountant of the business comes across certain reasons of differences for which adjustments are required to be made within the cash book. These reasons may include wrong accounting treatment of banking transactions in the business records or omission of certain transactions with bank.

Nature and Behaviour of Balances

It is important to know the nature and behavior of two balances before unfolding the possible reasons of difference among the two balances.

Balances as per:	Favorable or Unfavorable Balance	Deposit account (Favorable for the entity/business)	Overdraft account (Unfavorable for the entity/business)
Business Record _ Cash Book (Bank Column) _ Bank a/c _ Bank Book		Dr. Entity's Asset	Cr. Entity's Liability
Bank Record _ Bank Statement _Pass Book		Cr. Bank's Liability	Dr. Bank's Asset

<u>Important Tips to Remember (ITTRs):</u>

1. Deposit account does not mean fixed deposit or time deposit account.
2. There are two types of deposit account:
   - (i) Fixed/Time Deposit Account.
   - (ii) Demand Deposit Account.
3. BRS is prepared for demand deposit accounts only. These may be:
   - (i) Current Account, and
   - (ii) Profit and Loss Sharing Account, also known as Saving Account.
4. Transactions take place frequently in demand deposit accounts.
5. Time deposit accounts are kept for fixed period.
6. Further deposits and withdrawals are not made in time deposit account till its maturity.

Possible reasons of difference among the two balances

Possible reasons of difference among the "*balance as per cash book*" and "*balance as per bank statement*" can be subdivided into two:

1. Adjusting items
2. Reconciling items

1. **Adjusting Items:** Those need adjustments in cash book

a) Not yet recorded in cash book

		Effect in Cash Book
• Credit transfers	(collections)	**Dr**
• Direct debits	(payments)	**Cr**
• Standing orders	(payments)	**Cr**
• Bank charges	(deductions)	**Cr**
• Interest on overdrawn balance	(deductions)	**Cr**
• Deposited cheque returned dishonoured	(deductions)	**Cr**

b) Mistakes committed in cash book

• Receipts side mistakenly overstated	**Cr**
• Receipts side mistakenly understated	**Dr**
• Payments side mistakenly overstated	**Dr**
• Payments side mistakenly understated	**Cr**
• Issued cheque returned dishonoured but in replacement a new cheque was issued immediately	**(No effect in cash book)**

2. **Reconciling Items:** Those need to be presented in bank reconciliation statement

a) **Not yet recorded in the bank statement**

	Effect in BRS
• A cheque from a customer recorded in cash book and also deposited but not yet collected by the bank	**Cr**
• Cheques paid to suppliers recorded in cash book but not yet presented to the bank for payment	**Dr**

b) Mistakes committed in bank statement

• Wrongly debited/charged by the bank	**Cr**
• Wrongly credited by the bank	**Dr**

Practice 7.1

The balance as per Yasin Trader's cash book (bank column) Rs.4,500 does not agree with the balance as per bank statement Rs.7,700 on December 31, 20X9.

An investigation reveals following facts:

1. Cheques from customers of Rs.2,000 have been paid into the bank but have not yet been processed/cleared.
2. Cheques paid to suppliers of Rs.6,200 have not yet been presented to the bank for payment
3. The bank statement shows Rs.700 as bank charges that are yet to be recorded in the cash book.
4. A cheque for Rs.300 received from a customer has been returned dishonoured and could not be rectified in the cash book.

Answer:

Adjusted Cash Book (Bank Column)

Date	Receipts	Amount Rs.	Date	Payments	Amount Rs.
2009	Balance b/f (re-opened)	4,500	2009	Bank charges	700
Dec.31			Dec.31	Cheques Dishonored	300
				Balance c/f	3,500
		4,500			**4,500**

Bank Reconciliation Statement
As on December 31, 20X9

	Rs.		
Balance as per Bank Statement (favorable)	Cr		7,700
Un-collected Cheques	Cr		2,000
Un-presented Cheques	Dr		6,200
Corrected Balance	**Cr**		**3,500**
Balance as per adjusted cash book (bank column)	***Dr***	***3,500***	

Practice 7.2

Following information relates to the bank balance of Sethi Industries for the month of June 20X9.

Bank Reconciliation Statement
As on May 31, 20X9

		Rs.	**Rs.**
Balance as per Bank Statement			Cr. 5,000
Unpresented Cheques			
	Rashid Kamal	1,700	
	Asad Ali	1,300	Dr. 3,000
Uncollected Cheques			
	Nauman Zikria	2,800	
	Munir Ishaq	1,200	Cr. 4,000
			Cr. 6,000
Balance as per Cash Book			**Dr. 6,000**

Cash Book (Bank column)

Jun 20X9		Rs.	June 20X9		Rs.
1	Balance b/f	6,000	6	Fareed ud Din	800
2	Abbass Elahi	950	18	Rent	1,500
3	Bilal Mushtaq	450	20	Ghulam Abbas	1,400
10	Chiragh Din	2,000	27	Haider Ali	1,600
19	Dilnawaz khan	1,250	30	Ismail Rana	1,200
29	Elahi Buksh	850	30	Balance b/f	5,000
		11,500			**11,500**

Bank Statement
June 1, 20X9 to June 30, 20X9

Jun 20X9		Dr. Rs.	Cr. Rs.	Balance Rs.
1	Balance b/f			Cr. 5,000
2	Nauman Zikria		2,800	7,800
3	Abbas Elahi		950	8,750
3	Munir Ishaq		1,200	9,950
5	Bilal Mushtaq		450	10,400
7	Fareed ud Din	800		9,600
13	Chiragh Din		2,000	11,600
13	Bank charges	20		11,580
19	Rent	1,500		10,080
22	Chamber of Commerce Subscription (Standing order)	3,000		7,080
25	Asad Ali	1,300		5,780
28	Credit transfer (Bad Debts recovered)		120	5,900
30	Electricity Bill (Direct Debit)	900		Cr. 5,000

Required:

1 Prepare adjusted Cash Book for June, 20X9

2 Prepare Bank Reconciliation Statement as on June 30, 20X9.

3 Pass adjusting entries in Journal of Sethi Industries.

Answer:

Adjusted Cash Book

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
20X9			**20X9**		
June30	Balance b/f	5,000	June 30	Bank Charges	20
	Credit transfer	120		Subscription chamber of Commerce (standing order)	3,000
				Electricity Bill (Direct debit)	900
				Balance c/f	1,200
		5 ,120			5,120

Bank Reconciliation Statement
As on June 30, 20X9

	Rs.	Rs.
Balance as per Bank Statement		Cr. 5,000
Uncollected Cheques:		
Dilnawaz Khan	1,250	
Elahi Buksh	850	Cr. 2,100
Unpresented Cheques:		
Rashid Kamal (May)	1,700	
Ghulam Abbas	1,400	
Haider Ali	1,600	
Ismail Rana	1,200	Dr. 5,900
		Cr. 1,200
Balance as per Adjusted Cash Book		Dr. 1,200

Journal Entries

		Rs.	Rs.
1	Bank Charges A/c.	20	
	Bank A/c.		20
2	Trade subscription A/c.	3,000	
	Bank A/c.		3,000
3	Electricity Bill A/c.	900	
	Bank A/c.		900
4	Bank A/c.	120	
	Bad Debts recovered A/c.		120

Practice 7.3

Books of Mehran Bros.
Cash Book (Bank Column)

Dr. **Cr.**

Dec. 20X8		Rs.	Dec. 20X8		Rs.
1	Balance b/f	760	3	Drawings	400
7	Warda	840	11	Fateh Din	2,380
15	Danish	2,000	15	Cheque Book	20
19	Faiqa	2,620	24	Pervaiz	1,040
29	Bashir	600	26	Haris	760
31	Ghazal	360	29	Ghazanfar	220
			29	Commission	20
			29	Wages & Salaries	800
			31	Balance c/f	1,540
		7,180			7,180

Bank Statement
Mehran Bros. in Current Account with Bank

Dr. **Cr.**

Jan. 20X9		Rs.	Jan. 20X9		Rs.
2	Pervaiz	1,040	1	Balance b/f	1,840
4	Humaira	80	3	Bashir	600
5	Bashir (Cheque dishonored)	600	4	Steel Co.	1,230
6	Dilbar	450	5	Ghazal	360
8	Babar	150	9	Dilawar	750
9	Ghazanfar	220			

Prepare a bank reconciliation statement as on December 31, 20X8 and compare the pattern of this question with the pattern of Practice 7.2.

Answer:

Bank Reconciliation Statement
As on December 31, 20X8

	Rs.	Rs.
Balance as per Bank Statement on December 31, 20X8		Cr. 1,840
Uncollected Cheques:		
Bashir	600	
Ghazal	360	Cr. 960
Unpresented Cheques:		
Pervaiz	1,040	
Ghazanfar	220	Dr. 1,260
		Cr. 1,540
Balance as per Cash Book on December 31, 20X8		Dr. 1,540

<u>Important Tips To Remember (ITTRs)</u>

1. Balance to be shown in Statement of Financial Positions (Balance Sheet) would always be the **balance as per adjusted cash book**.
2. Uncollected cheques are also named as: uncleared cheque, uncredited cheques, uncleared lodgments, deposits in transit and outstanding lodgments.
3. Unpresented cheques are also named as outstanding cheques, uncashed cheques, unpaid cheques.
4. When both balances are given in a question then prepare bank reconciliation statement starting with balance as per bank statement.
5. When only the balance as per cash book is given in the question then first prepare adjusted cash book and then prepare BRS starting with the balance as per adjusted cash book.
6. When only the balance as per bank statement is given; first prepare BRS to find out the balance as per adjusted cash book then put this balance in adjusted cash book as a closing balance and then find out the opening balance of cash book (balance before adjustments) that would be a balancing figure.
7. Never mix up adjusting and reconciling items in one statement, always prepare adjusted cash book and BRS separately.
8. Bank deposit account are mainly of two types; time deposits and demand deposits. Time deposits are the balances held with bank for long-term (non-current assets) as well as for short-term (current assets). Demand deposits are the balances held in current accounts or saving (PLS) accounts. BRS is prepared for demand deposits accounts only.
9. Accounting entries are passed for those reasons that need adjustments in cash book *(adjusting items)*

a)

Transactions not recorded in cash book	**Effect in Cash Book**
• Credit transfers	**Dr** Bank A/c **Cr** Income/Receivable A/c
• Direct debits	**Dr** Expense/Creditor A/c **Cr** Bank A/c
• Standing order	**Dr** Expense/Creditor A/c **Cr** Bank A/c
• Bank charges	**Dr** Bank Charges A/c **Cr** Bank A/c
• Interest on overdrawn balance	**Dr** Interest on Bank OD A/c. **Cr** Bank A/c
• Deposited cheque returned dishonoured	**Dr** Debtors A/c. **Cr** Bank A/c

b)

Mistakes committed in cash book	
• Receipts side mistakenly overstated	**Dr** Suspense A/c **Cr** Bank A/c
• Receipts side mistakenly understated	**Dr** Bank A/c **Cr** Suspense A/c
• Payments side mistakenly overstated	**Dr** Bank A/c **Cr** suspense A/c
• Payments side mistakenly understated	**Dr** Suspense A/c **Cr** Bank A/c
• Issued cheque returned dishonoured but in replacement a new cheque was issued immediately	**(No effect in the book of accounts)**

Exercise Question

Q. 1

Books of Mehran Bros.

Cash Book (Bank Column)

Dr. Cr.

Dec. 20X8		Rs.	Dec. 20X8		Rs.
1	Balance b/f	760	3	Drawings	400
7	Warda	840	11	Fateh Din	2,380
15	Danish	2,000	15	Cheque Book	20
19	Faiqa	2,620	24	Pervaiz	1,040
29	Bashir	600	26	Haris	760
31	Ghazal	360	29	Ghazanfar	220
			29	Commission	20
			29	Wages & Salaries	800
			31	Balance c/f	1,540
		7,180			7,180

Bank Statement
Mehran Bros. in Current Account with Bank

Dr. Cr.

Jan. 20X9		Rs.	Jan. 20X9		Rs.
2	Pervaiz	1,040	1	Balance b/f	1,840
4	Humaira	80	3	Bashir	600
5	Bashir (Cheque dishonored)	600	4	Steel Co.	1,230
6	Dilbar	450	5	Ghazal	360
8	Babar	150	9	Dilawar	750
9	Ghazanfar	220			

Prepare a bank reconciliation statement as on December 31, 20X8

Answer:

Bank Reconciliation Statement
As on December 31, 20X8

	Rs.	Rs.
Balance as per Bank Statement on December 31, 20X8		Cr. 1,840
Uncollected Cheques:		
Bashir	600	
Ghazal	360	Cr. 960
Unpresented Cheques:		
Pervaiz	1,040	
Ghazanfar	220	Dr. 1,260
		Cr. 1,540
Balance as per Cash Book on December 31, 20X8		Dr. 1,540

Examination Question

4. The balance in Iqbal's cash book is Rs.850 debit. This balance includes the following:

1) Rs.300 cheques which have been drawn but not yet presented to the bank
2) Rs.1,000 deposits made but not yet credited in the bank statement
3) Iqbal has forgotten to enter a direct debit payment of Rs.100 in his cash book.

Once these adjustments have been made the cash book and bank statements will agree.

What was the balance on Iqbal's bank statement?

a) Rs.1,450 favorable
b) Rs.150 unfavorable
c) Rs.50 favorable
d) Rs.1,550 favorable

5. Sharmin's bank statement at 31 October 20X8 shows a balance of Rs.13,400. She subsequently discovers that the bank has dishonored a customer's cheque for Rs.300 and has charged bank charges of Rs.50, neither of which is recorded in the cash book. There are unpresented cheques totaling Rs.1,400 and an automatic receipt from a customer of Rs.195 has been recorded as a credit in Sharmin's cash book.

Sharmin's cash book balance, prior to correcting the errors and omissions, was:

a) Rs.11,455 favorable
b) Rs.11,960 favorable
c) Rs.12,000 favorable
d) Rs.12,155 favorable

6. The following bank reconciliation statement has been prepared by an inexperienced bookkeeper at 31 December 20X8:

	Rs.
Balance per bank statement (overdrawn)	38,640
Add: Lodgments not credited	19,270
	57,910
Less: Unpresented cheques	14,260
Balance per cash book	**43,650**

What should the final cash book balance be when all the above items have been properly dealt with?

A. Rs.43,650 overdrawn
B. Rs.33,630 overdrawn
C. Rs.5,110 overdrawn
D. Rs.72,170 overdrawn

7. A company's cashbook shows a debit balance of Rs.700. The bank statement as at the same date shows an overdrawn balance of Rs.210.

Which one of the following timing differences could account for the discrepancy?

A. Cheques drawn but not yet presented Rs.490
B. Cheques deposited but not yet cleared Rs.490
C. Cheques drawn but not yet presented Rs.910
D. Cheques deposited but not yet cleared Rs.910

Chapter – 8

ACCRUAL ACCOUNTING

Sr. No	Course Outline Topics
1	Basic Concepts of Accruals based Accounting
2	Technique for calculating expense for the year
3	Technique for calculating income for the year
4	One and two account method approach - Expense in arrear
5	One and two account method approach - Expense in advance
6	Accrued Income
7	Advance Income
8	Diagrammatic understanding of Accruals and Prepayments
9	Adjusting and Closing entries

Topic 069 – 077 are included in this chapter.

Cash and Accrual Basis of Accounting

There are two bases to present financial performance of a business entity; 1) Cash basis and 2) Accrual basis.

Conventionally, small business entities prepare financial statements on *"Cash Basis",* where all the cash payments during the current accounting period are recognized as expense, except for owners' drawing, acquiring long lived assets and repayment of loans. In the same way all cash receipts during one accounting period are recognized as income, except for receipt of capital from owner, collection of cash by selling long lived assets and receiving cash as loan.

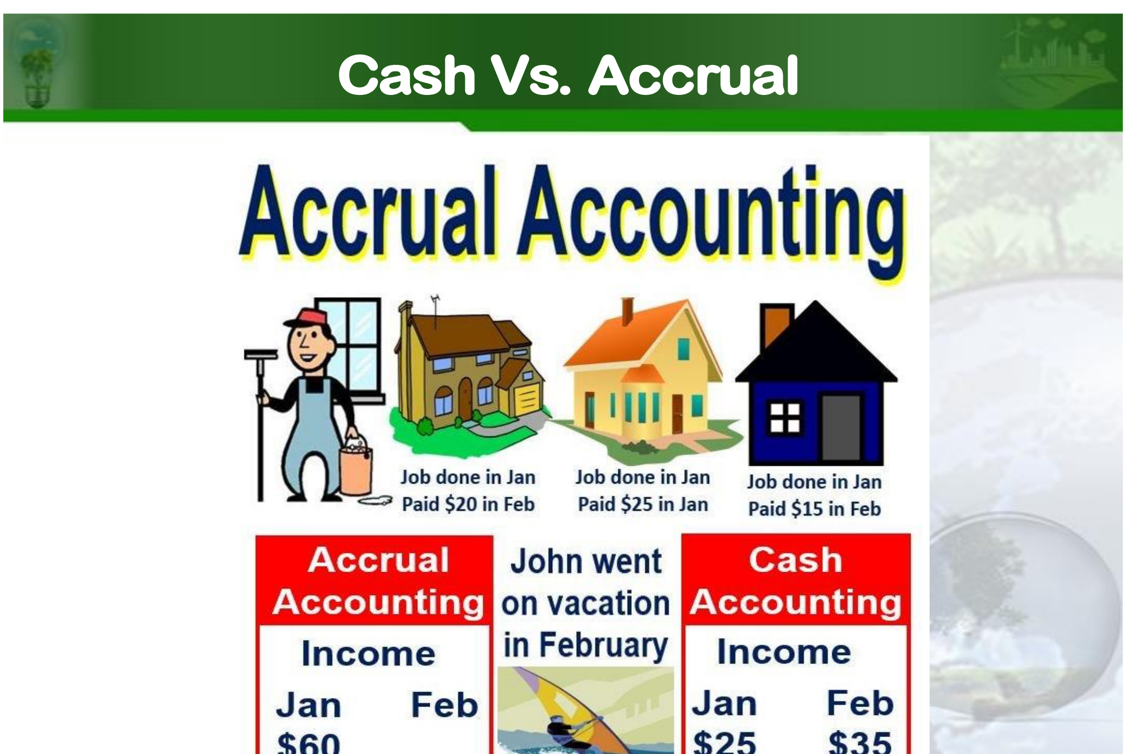
Under cash basis of accounting it is not consider whether the economic benefit associated to such cash payments or receipts belong to the current, previous or the future accounting/reporting period.

Cash basis of preparing financial statements is very easy to handle and less costly, because no complex accounting system is required to be developed and implemented.

The business entities of considerable size follow "*Accrual Basis"*, where expenses and incomes are measured based on the matching principle of accounting for measuring accurate performance of the business entity. Expenses that belong to a specific accounting/reporting period are subtracted from the Incomes that belong to the same specific period. It does not consider whether the cash has been paid for such expenses or not and the cash has been received for those incomes or not. In certain cases, cash had paid in advance in the previous accounting period or cash will be paid in the next accounting/reporting period but its expense is recognized in the current accounting period. Same scenario applies to incomes.

Since the expenses are recognized in the current period on accrual basis; their reciprocal outstanding payment is recognized as liability and if the expense is not recognized in the current period despite its payment has been made in advance then its reciprocal prepayment is recognized as asset. In the same way, since the incomes are recognized in the current period on accrual basis; their reciprocal outstanding collection is recognized as asset and if the income was not recognized in the current period despite its cash has been received in advance then its reciprocal collection is recognized as liability.

Although little complex but accrual concept is very interesting to learn. Following formulae will help in calculating accurate amount of expense and income for the period under accrual basis.



Technique for calculating expense for the year (for the reporting period)

Expenses (with closing balances of: 1) accrued expense due and 2) advance payment)

	Expenses Paid	(During the year) *appearing in* ***cash book payment side***
Add	Closing accrued/due	(Expenses for current year still to be paid) ***Liability***
Less	Closing advance/prepayment	(Advance payment for expense made) ***Asset***
	Expenses for the year	(It is closed to Income Statement as *Expense*)

Expenses (with opening and closing balances of: 1) accrued expense due and 2) advance payment)

	Expenses Paid	(During the year) *appearing in* ***cash book payment side***
Add	Closing accrued/due	(Expenses for the year still to be paid) ***Liability***
Less	Opening accrued/due	(Liability that was paid during the current year)
Less	Closing advance/prepayment	(Advance payment for expense made) ***Asset***
Add	Opening advance/prepayment	(Paid in previous year for the current year)
	Expenses for the year	(It is closed to Income Statement as *Expense*)

Practice 8.1

Cash paid for expense during the year Rs.7,000, opening balance of expense due was Rs.250 and opening balance of prepaid expenses was Rs.400, on closing date expense still due is Rs.300 and prepaid expense is Rs.700

Required: Prepare expense a/c, expense due a/c and prepaid expense a/c

Expense account

Particular	Debit Rs.	Particulars	Credit Rs.
Op. Advance	400	Op. Owing	250
Cash Paid	7,000	Cl. Advance	700
Cl. Owing	300	Profit & Loss (balancing figure)	**6,750**
	7,700		7,700

Accrued (Due) Expenses account

Particular	Rs.	Particulars	Rs.
Op Bal transferred to Exp. A/c	250	Balance b/f	250
Balance c/f	300	Cl owing charged to Exp. a/c	300
	550		550

Prepaid (Advance) Expenses account

Particular	Rs.	Particulars	Rs.
Balance b/f	400	Op Balance Charged to Exp. a/c	400
Cl Adv transferred from Exp. a/c	700	Balance c/f	700
	1100		1100

Technique for calculating income for the year (reporting period)

For Incomes (with closing balances for income owing and advance receipt):

	Income Received	(During the year) *Cash book receipt side*
+	Closing owing/due	(Income for current year still to be received) *Asset*
-	Closing advance/unearned	(Advance Receipts for next year) *Liability*
	Incomes for the year	(It is closed to Income Statement as *Income*)

For Incomes (with opening and closing balances for income owing and advance receipt):

	Income Received	(During the year) *Cash book receipt side*
+	Closing owing/due	(Income for current year still to be received) *Asset*
-	Opening owing/due	(Asset that was received during the current year)
-	Closing advance/unearned	(Advance Receipts for next year) *Liability*
+	Opening advance/unearned	(Received in previous year for the current year)
	Incomes for the year	(It is closed to Income Statement as *Income*)

Practice 8.2

Income received during the year Rs.3,000, opening balance of income due was Rs.150 and opening balance of unearned income was Rs.500, on closing date income still due is Rs.70 and unearned income on closing date is Rs.50.

Required: Prepare income a/c, income due a/c and unearned income A/c.

Income Account

Particular	**Debit Rs.**	**Particulars**	**Credit Rs.**
Opening Owing	150	Opening Advance	500
Closing Advance	50	Cash Received	3,000
Profit & Loss (balancing figure)	**3,370**	Closing Owing	70
	3,570		3,570

Accrued (Due) Income Account

Particular	**Rs.**	**Particulars**	**Rs.**
Balance b/f	150	Op Bal transferred to Income a/c	150
Cl Bal transferred from Income a/c	70	Balance c/f	70
	220		220

Unearned (Advance) Income Account

Particular	**Rs.**	**Particulars**	**Rs.**
Op Bal transferred to Income A/c.	500	Balance b/f	500
Balance c/f	50	Cl Bal transferred from Income a/c	50
	550		550

For Statement of Financial Position (Balance Sheet)

Expense Due	__________	Liability
Income Due	__________	Asset
Advance Payment	__________	Asset
Advance Receipts	__________	Liability

Practice 8.3

Rent is paid quarterly **in arrear**:

Payment Date	**Payment Period**	**Amount (Rs.)**
Jan 31, 20X8	Nov X7, Dec X7, Jan X8	9,000
Apr 30, 20X8	Feb X8, March X8, Apr X8	9,500
July 31, 20X8	May X8, June X8, July X8	10,000
Oct 31, 20X8	Aug X8, Sep X8, Oct X8	10,000
Jan 31, 20X9	Nov X8, Dec X8, Jan X9	10,500

Reporting Period **(Jan 1, 20X8 to Dec 31,20X8)**

		Rs.
Cash paid during the year	(W-3) – 1st Jan X8 to 31st Dec X8	38,500
Less: Opening Accrual	(W - 1) – Nov X7 and Dec X7	(6,000)
Add: Closing Accruals	(W - 2) – Nov X8 and Dec X8	7,000
Expense for the year		**39,500**

W – 1: Opening Accruals = $9,000 \text{ X } \frac{2}{3}$ = 6,000

W – 2: Closing Accruals = $10,500 \text{ X } \frac{2}{3}$ = 7,000

W – 3: Cash paid = 9,000 + 9,500 + 10,000 + 10,000 = 38,500

One Account Method:

Rent Payable A/c.

	Rs.		**Rs.**
Cash paid	38,500	Opening rent payable balance b/f	6,000
Closing rent payable balance c/f	7,000	**Profit & Loss (balancing figure)**	**39,500**
	45,500		45,500

Accounting Entries

Particulars	**Debit Rs.**	**Credit Rs.**
Rent Payable A/c.	38,500	
Cash A/c.		38,500
(Rent paid in cash)		
Profit & Loss A/c.	39,500	
Rent Payable A/c.		39,500
(Closing entry for rent expense – Closed into Income Statement)		

Two Account Method

Rent Payable A/c.

	Rs.		Rs.
Rent expense	6,000	Opening rent payable balance b/f	6,000
Closing rent payable balance c/f	7,000	Rent expense	7,000
	13,000		13,000

Rent Expense A/c.

	Rs.		Rs.
Cash paid	38,500	Rent Payable (Opening balance)	6,000
Rent Payable (Closing balance)	7,000	**Profit & Loss (balancing figure)**	**39,500**
	45,500		45,500

Particulars	Debit Rs.	Credit Rs.
Rent Expense A/c. Cash A/c. (Rent paid in cash)	38,500	38,500
Rent Payable A/c. Rent Expense A/c. (Opening balance rent due transferred)	6,000	6,000
Rent expense A/c. Rent Payable A/c. (Rent of current year is still due.)	7,000	7,000
Profit & Loss A/c. Rent Expense A/c. (Closing entry for rent expense – Closed into Income Statement)	39,500	39,500

Practice 8.4

Rent is paid Quarterly **in Advance**

Payment Date	**Payment Period**	**Amount (Rs.)**
Nov. 1, 20X8	Nov X8, Dec X8, Jan X9	9,000
Feb. 1, 20X9	Feb X9, Mar X9, Apr X9	9,500
May 1, 20X9	May X9, June X9, Jul X9	10,000
Aug. 1, 20X9	Aug X9, Sep X9, Oct X9	10,000
Nov. 1, 20X9	Nov X9, Dec X9, Jan Y0	10,500

Reporting Period (Jan. 1, 20X9 to Dec. 31, 20X9)

		Rs.
Cash paid during the year	(W-3) – 1ST Jan 20X9 to 31st Dec 20X9	40,000
Add: Opening Advance	(W - 1) – Jan 20X9	3,000
Less: Closing Advance	(W - 2) – Jan 20Y0	(3,500)
Expense for the year		39,500

W – 1: Opening Advance = $9{,}000 \text{ X } \frac{1}{3} = 3{,}000$

W – 2: Closing Advance = $10{,}500 \text{ X } \frac{1}{3} = 3{,}500$

W – 3: Cash paid = 9,500 + 10,000 + 10,000 + 10,500 = 40,000

One Account Method:

Prepaid (Advance) Rent A/c.

	Rs.		**Rs.**
Opening prepaid rent balance b/f	3,000	**Profit & Loss (balancing figure)**	**39,500**
Cash paid	40,000	Closing prepaid rent balance c/f	3,500
	43,000		43,000

Particulars	**Debit Rs.**	**Credit Rs.**
Prepaid (Advance) Rent A/c.	40,000	
Cash A/c.		40,000
(Rent paid in cash)		
Profit & Loss A/c.	39,500	
Prepaid (Advance) Rent A/c.		39,500
(Closing entry for rent expense – Closed into Income Statement)		

Two Account Method

Advance Rent A/c.

	Rs		Rs.
Balance b/f	3,000	Rent Expense	3,000
Rent Expense	3,500	Balance c/f	3,500
	6,500		6,500

Rent Expense A/c.

	Rs		Rs.
Opening advance rent	3,000	Closing advance rent	3,500
Cash paid	40,000	**Profit & Loss (B)**	39,500
	43,000		43,000

Accounting Entries

Particulars	Debit Rs.	Credit Rs.
Rent Expense A/c.	40,000	
Cash A/c.		40,000
(Rent paid in cash.)		
Rent Expense A/c.	3,000	
Advance Rent A/c.		3,000
(Opening balance of advance rent transferred)		
Advance Rent A/c.	3,500	
Rent Expense A/c.		3,500
(Rent paid in advance transferred from rent Expense)		
Income Statement A/c.	39,500	
Rent Expense A/c.		39,500
(Closing entry for rent expense.)		

Practice 8.5 **(Income in Arrear)**

Rent is received quarterly **in arrear**:

Receipt Date	Receipt Period	Amount (Rs.)
Jan 31, 20X8	Nov X7, Dec X7, Jan X8	9,000
Apr 30, 20X8	Feb X8, March X8, Apr X8	9,500
July 31, 20X8	May X8, June X8, July X8	10,000
Oct 31, 20X8	Aug X8, Sep X8, Oct X8	10,000
Jan 31, 20X9	Nov X8, Dec X8, Jan X9	10,500

Reporting Period **(Jan 1, 20X8 to Dec 31,20X8)**

		Rs.
Cash received during the year	(W-3) – 1st Jan X8 to 31st Dec X8	38,500
Less: Opening Accrual	(W - 1) – Nov X7 and Dec X7	(6,000)
Add: Closing Accrual	(W - 2) – Nov X8 and Dec X8	7,000
Income for the year		**39,500**

W – 1: Opening Accruals $= 9{,}000 \times \frac{2}{3} = 6{,}000$

W – 2: Closing Accruals $= 10{,}500 \times \frac{2}{3} = 7{,}000$

W – 3: Cash paid $= 9{,}000 + 9{,}500 + 10{,}000 + 10{,}000 = 38{,}500$

One Account Method:

Rent Receivable A/c.

	Rs.		Rs.
Opening rent receivable balance b/f	6,000	Cash received	38,500
Profit & Loss (balancing figure)	**39,500**	Closing rent receivable balance c/f	7,000
	45,500		45,500

Accounting Entries

Particulars	Debit Rs.	Credit Rs.
Cash A/c.	38,500	
Rent receivable A/c.		38,500
(Rent received in cash)		
Rent receivable A/c.	39,500	
Profit & Loss A/c.		39,500
(Closing entry for rent income – Closed into Income Statement)		

Two Account Method

Rent Receivable A/c.

	Rs.		Rs.
Opening rent receivable balance b/f	6,000	Rent income	6,000
Rent income	7,000	Closing rent receivable balance c/f	7,000
	13,000		13,000

Rent Income A/c.

	Rs.		Rs.
Rent receivable opening	6,000	Cash received	38,500
Profit & Loss (balancing figure)	39,500	Rent receivable closing	**7,000**
	45,500		45,500

Particulars	Debit Rs.	Credit Rs.
Cash A/c.	38,500	
Rent income A/c.		38,500
(Rent received in cash)		
Rent Income A/c.	6,000	
Rent Receivable A/c.		6,000
(Opening balance rent due transferred)		
Rent Receivable A/c.	7,000	
Rent Income A/c.		7,000
(Rent of current year is still due.)		
Rent Income A/c.	39,500	
Profit & Loss A/c.		39,500
(Closing entry for rent income – Closed into Income Statement)		

Practice 8.6 (Income in Advance)

Rent is received Quarterly **in Advance**

Receipt Date	Receipt Period	Amount (Rs.)
Nov. 1, 20X8	Nov X8, Dec X8, Jan X9	9,000
Feb. 1, 20X9	Feb X9, Mar X9, Apr X9	9,500
May 1, 20X9	May X9, June X9, Jul X9	10,000
Aug. 1, 20X9	Aug X9, Sep X9, Oct X9	10,000
Nov. 1, 20X9	Nov X9, Dec X9, Jan Y0	10,500

Reporting Period (Jan. 1, 20X9 to Dec. 31, 20X9)

		Rs.
Cash received during the year	(W-3) – 1ST Jan 20X9 to 31st Dec 20X9	40,000
Add: Opening Advance	(W - 1) – Jan 20X9	3,000
Less: Closing Advance	(W - 2) – Jan 20Y0	(3,500)
Income for the year		39,500

W – 1: Opening Advance = $9{,}000 \times \frac{1}{3} = 3{,}000$

W – 2: Closing Advance = $10{,}500 \times \frac{1}{3} = 3{,}500$

W – 3: Cash Received = 9,500 + 10,000 + 10,000 + 10,500 = 40,000

One Account Method:

Unearned (Advance) Rent A/c.

	Rs.		Rs.
Profit & Loss (balancing figure)	39,500	Opening advance rent b/f	3,000
Closing Advance rent c/f	3,500	Cash Received	40,000
	43,000		43,000

Particulars	Debit Rs.	Credit Rs.
Cash A/c.	40,000	
Unearned (Advance) Rent A/c.		40,000
(Rent received in cash)		
Unearned (Advance) Rent A/c.	39,500	
Profit & Loss A/c.		39,500
(Closing entry for rent income – Closed into Income Statement)		

Two Account Method

Advance Rent A/c.

	Rs		Rs.
Rent Income A/c	3,000	Balance b/f	3,000
Balance c/f	3,500	Rent Income A/c	3,500
	6,500		6,500

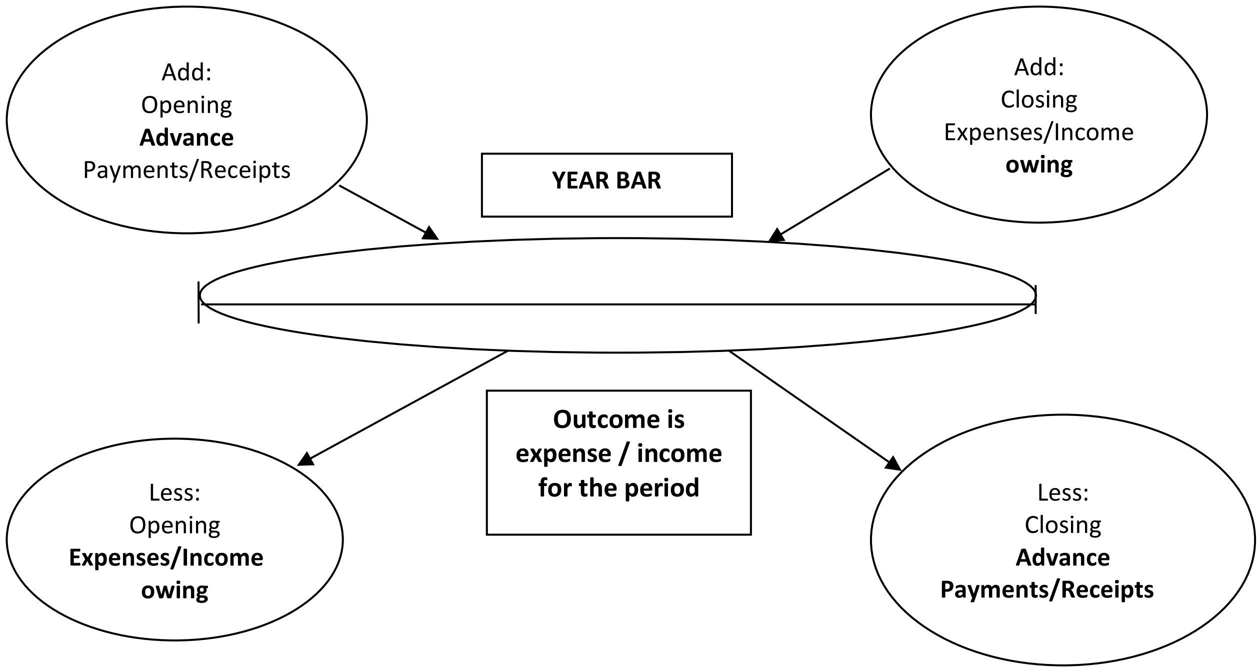
Rent Income A/c.

	Rs		Rs.
Advance Rent Closing	3,500	Advance Rent Opening	3,000
Profit & Loss (B)	39,500	Cash Received	40,000
	43,000		43,000

Accounting Entries

Particulars	Debit Rs.	Credit Rs.
Cash A/c.	40,000	
Rent Income A/c.		40,000
(Rent income received in cash)		
Advance Rent A/c.	3,000	
Rent Income A/c.		3,000
(Opening balance of advance rent transferred)		
Rent Income A/c.	3,500	
Advance Rent A/c.		3,500
(Rent received in advance transferred from rent Income)		
Rent Income A/c.	39,500	
Profit & Loss A/c.		39,500
(Closing entry for rent income)		

Diagrammatic Understanding of Accruals and Prepayments



Practice 8.7

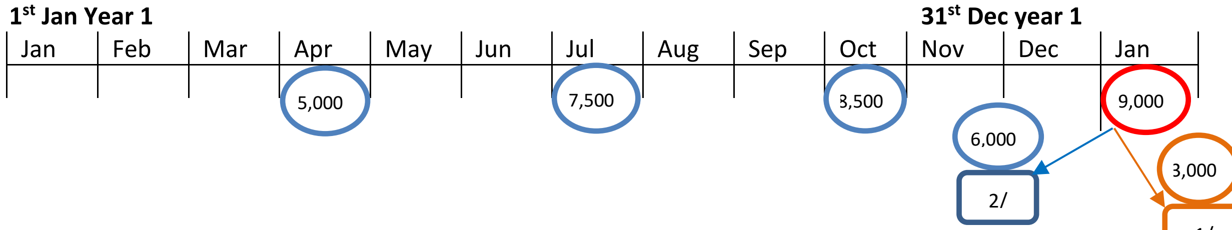
YEAR 1

- Yasin sets up a business on 1st January year 1 with 31st December as end of reporting period
- He acquires a telephone connection on 1st February and agrees to pay bill quarterly (3 months) in arrear
- Year 1 invoices are paid as follows:
  - 3 months ending 30th April year 1 Rs.5,000
  - 3 months ending 31st July year 1 Rs.7,500
  - 3 months ending 31st October year 1 Rs.8,500
- The invoice as at 31st January year 2 is Rs.9,000

Year Ending 31st December

Opening date
1st Jan Year 1

Reporting date
31st Dec year 1



<u>**Telephone Expense for the year ending on 31st Dec Year 1 = 5,000 + 7,500 + 8,500 + 6,000 = Rs.27,000**</u>

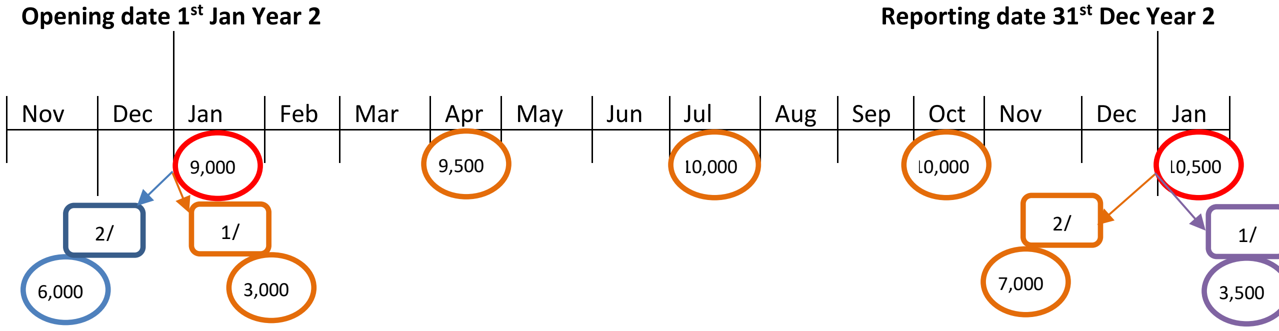
Rs.9,000 will be paid in next year out of which Rs.6,000 relates to the current reporting period and is accrued/due on reporting date 31st Dec Year 1.

YEAR 2

- Year 2 invoices are paid as follows:
  - 3 months ending 31st January year 2 Rs.9,000
  - 3 months ending 30th April year 2 Rs.9,500
  - 3 months ending 31st July year 2 Rs.10,000
  - 3 months ending 31st October year 2 Rs.10,000
- The invoice as at 31st January year 3 is expected to be Rs.10,500

Year Ending 31st December

Opening date 1st Jan Year 2 **Reporting date 31st Dec Year 2**



<u>**Telephone Expense for the year ending on 31st Dec. Year 2 = 3,000 + 9,500 + 10,000 + 10,000 + 7,000 = Rs.39,500**</u>

Rs.10,500 will be paid in next year out of which Rs.7,000 relates to the current reporting period and is accrued/due on reporting date 31st Dec Year 2.

Answer:

- One account method
- Two account method

One account method

YEAR 1

Telephone Payable Account

		Rs.			Rs.
Apr 30	Bank	5,000	Dec 31	**Profit & Loss (balancing figure)**	**27,000**
July 31	Bank	7,500			
Oct 30	Bank	8,500			
Dec 31	Closing due	6,000			
		27,000			27,000

One account method

YEAR 2

Telephone Payable Account

		Rs.			Rs.
Jan 31	Bank	9,000		Opening due	6,000
Apr 30	Bank	9,500	Dec 31	**Profit & Loss (Balancing figure)**	**39,500**
July 31	Bank	10,000			
Oct 30	Bank	10,000			
Dec 31	Closing due	7,000			
		45,500			45,500

Two account method

YEAR 1

Telephone Expenses Account

		Rs.			Rs.	
Apr 30	Bank	5,000	Dec 31			
July 31	Bank	7,500	**Profit & Loss**		**27,000**	Expenses
Oct 30	Bank	8,500	**(Balancing figure)**			Year 1
Dec 31	Payable a/c	6,000				
		27,000			27,000	

Telephone Payable Account

		Rs.		Rs.	
Dec 31			Dec 31		
	Bal c/f	6,000	Telephone expenses	6,000	Liability
					Year 1
		6,000		6,000	

Two account method

YEAR 2

Telephone Expenses Account

		Rs.	Jan 1	Rs.	
Jan 31	Bank	9,000	Telephone payable	6,000	Reversal of the accrual
Apr 30	Bank	9,500	Dec 31		
Jul 31	Bank	10,000	**Profit & Loss**	**39,500**	Expenses year 2
Oct 30	Bank	10,000	**(Balancing figure)**		
Dec 31	Tel payable	7,000			
		46,000		45,500	

Telephone Payable Account

	Rs.		Rs.	
Telephone exp.	6,000	Balance b/f	6,000	
Balance c/f	7,000	Telephone exp.	7,000	Liability Year 2
	13,000		13,000	

Adjusting Entries

Adjusting entries are passed on reporting (closing) date, in order to complete the Income/Expense account with respect to the accruals and prepayments.

For Opening Expense Due

Dr	Expense payable A/c.	Cr	Expense (accounting head)

For Closing Expense Due

Dr	Expense (accounting head)	Cr	Expense payable a/c

For Opening Advance Payment

Dr	Expense (accounting head)	Cr	Advance payment a/c

For Closing Advance payment

Dr	Advance payment A/c.	Cr	Expense (accounting head)

For Opening Income Due

Dr	Income (accounting head)	Cr	Income receivable a/c

For Closing Income Due

Dr	Income receivable a/c	Cr	Income (accounting head)

For Opening Advance Receipt

Dr	Unearned income a/c	Cr	Income (accounting head)

For Closing Advance Receipt

Dr	Income (accounting head)	Cr	Unearned Income A/c

Closing Entries

Closing entries are passed on reporting (closing) date, in order to close final balance of Income/Expense account into the Income Statement for the reporting period to which they relate.

For expenses

Dr	Income Statement	Cr	Expense (accounting head)

For incomes

Dr	Income (accounting head)	Cr	Income Statement

Important Tips To Remember (ITTRs)

1. “Opening expense due” means the expenses relating to previous reporting period, which have been paid during the current reporting period. These were recognized as liabilities in the previous balance sheet. Therefore, its payment should not be included in expense for the period.

2. “Closing expense due” means the expenses that relate to the current reporting period, which have not yet paid during the period. These are recognized as liabilities in the balance sheet at the end of current reporting period.

3. “Opening advance payment” means the expenses that relate to the current reporting period, which had been paid during the previous reporting period in advance. These were recognized as asset in the previous reporting date.

4. “Closing advance payment” means the expenses that relate to future reporting period, these have been paid during the current period as advance. These are recognized as asset in the balance sheet at the end of current reporting period.

5. The terminology “**due**” is alternatively termed as owing, outstanding, accrued and in-arrears. For expenses; it means not yet paid or payable. For incomes; it means not yet received or receivable.

6. The terminology “**advance**” for expense means; prepayments or unexpired cost and for incomes means; unearned incomes or deferred income.

7. Reporting date means the closing date of the reporting period also known as end of reporting period.

8. Opening expense due is subtracted from the cash paid for expenses during the current reporting period because such payment was made against the previous period’s liability for expenses that were not paid till the previous reporting date. Since, while recording transactions, this is recognized as expense of current reporting period therefore, it is rectified by subtracting the amount of opening expense due from the payments made for expenses during the period.

9. Opening prepayments are added in current period’s expense because; these were paid in previous period in advance for expenses relating to the current period. Another reason is that expiry of advance payments happens in current accounting period, therefore these are recognized as expense in the current periods.

10. Opening income due is subtracted from cash received for incomes during the current reporting period because such receipt was collected against the previous period’s receivables for incomes that were not received till the previous reporting date. Since, while recording transactions, this is recognized as income of current reporting period therefore, it is rectified by subtracting the amount of opening income due from the receipts collected for incomes during the period.

11. Opening advance receipts are added in current period’s incomes because these were received in previous period in advance for incomes relating to the current period.

12. Closing expense due is included in current expenses because it belongs to the current period. Its second effect is included in liabilities on reporting date because it is still payable.

13. Closing prepayment is subtracted from current period expenses because it does not belong to the current reporting period. Its second effect is recognized as asset because its economic benefits have not yet expired.

14. Closing income due is included in current incomes because it belongs to the current period. Its second effect is included in assets on reporting date because it is still receivable.

15. Closing advance receipt is subtracted from current period incomes because it does not belong to the current period. Its second effect is recognized as liability because its income has not yet earned.

Exercise and Examination Question Bank

1. Rent office space from 1 August 20X8 at Rs.18,000 per annum, payable quarterly in arrears

How much rental expense should be presented in the Income Statement for year-end 31st Dec 20X8?

Answer: **Rs.18,000 / 12 months = Rs.1,500 per month x 5 months = Rs. 7,500**

2. A tenant pays annual rent of Rs.6,000. Payment is made quarterly in advance on 1 January, 1 April, 1 July and 1 October.

Which of the following should be included in his accounts for the year ended 31 October 20X8?

A. RS.500 Accrual.
B. RS.500 Prepayment
C. RS.1,000 Accrual
D. RS.1,000 Prepayment

Answer: **Rs.6,000 / 12 months = Rs.500 per month. Prepaid for November and December Rs.1,000**

3. The gas account for the year ended 30 June 20X9 was as follows:

	RS.
Opening balance for gas accrued at 1 July 20X8	300
Payments made during the year:	
1 August 20X8 for three months to 31 July 20X8	600
1 November 20X8 for three months to 31 October 20X8	720
1 February 20X9 for three months to 31 January 20X9	900
30 June 20X9 for three months to 30 April 20X9	840

Which of the following is the appropriate entry for gas expense?

	Accrued at June 20X9	**Expense for the year**
A.	Rs. Nil	Rs.3,060
B.	Rs. 460	Rs.3,320
C.	**Rs. 560**	**Rs.3,320**
D.	Rs. 560	Rs.3,420

Answer: **Cash Paid during the year (600+720+900+840) – Opening Accrued 300 + Closing Accrued 560 (840 x 2/3 estimation made on the basis of last quarter's bill)**

4. Light and heat costs paid by cheque during the year ended 31 July 20X6 totaled Rs.9,400. On 15 September 20X6, a payment of Rs.3,030 was made covering the period 1 June 20X6 to 31 August 20X6. At 31 July 20X5, light and heat accrued was Rs.1,200.

What should be included in the income statement for the year ended 31 July 20X6 for light and heat?

A. Rs.8,580 (Cash paid 9,400 – opening accrued 2,020 [3,030x2/3] + closing accrued 1,200)
B. Rs.10,220
C. Rs.11,420
D. Rs.11,230

5. At 1 September, the motor expenses account showed 4 months' insurance prepaid of Rs.80 and petrol accrued of Rs.95. During September, the outstanding petrol bill is paid, plus further bills of Rs.245. At 30 September there is a further outstanding petrol bill of Rs.120.

The amount to be shown in the income statement for motor expenses for September is:

A. Rs.385
B. Rs.415
C. **Rs.445 (Op. Adv. 80 – Op Acc. 95 + paid in period (245+95) + cl. due 120)**
D. Rs.460

6. Are the following statements about effect of accrued expense True or False?

	True	False
Profit Reduces	☐	☐
Net assets Reduces	☐	☐

Both are TRUE because by recording accruals; expense is increased that reduces profits and liability is also increased that reduces net assets

7. Jaffar owns two rental properties. The following balances were extracted from the accounting records in respect of rent for each property:

	Property 1	Property 2
As at 30 June 20X6	Rs.5000 Dr	Rs.10,000 Cr
As at 30 June 20X7	Rs.8,000 Cr	Rs.2,000 Dr

During the year ended 30 June 20X7, Jaffar received in cash RS.80,000 from Property 1 and RS.90,000 from Property 2.

What total revenue should be included in the income statement for the year ended 30 June 20X7?

A. Rs.171,000
B. Rs.155,000
C. Rs.169,000
D. Rs.181,000
Cash received 170,000 – opening due 5,000 + opening advance 10,000 – closing advance 8,000 + closing due 2,000

8. **Expenses for the period, which remains unpaid at the end of the period, should be?**

A. **Debited to income statement and included in the statement of financial position as current liability**
B. Shown in the income statement as an expense and deducted from statement of financial position cash figure at the end of the year (it's not yet paid therefore deducting from cash is wrong)
C. Shown as liability in the statement of financial position only (second effect is missing)
D. Shown as a prepayment in the statement of financial position (it's not prepayment, it is accrued)

9. Rent expense appearing in the income statement for a year was Rs.4,000. Whereas, Rs.200 was prepaid at the start of the year and Rs.400 was owing at the end of year.

What was the cash book figure for rent paid during the year?

A. Rs.4,000
B. Rs.3,800
C. Rs.4,200
D. Rs.3,400 **(Expense for the year 4,000 – opening advance 200 – closing due 400)**

CHAPTER – 9

PROVISION FOR DOUBTFUL DEBTS AND ALLOWABLE DISCOUNTS

Sr. No	Course outline Topics - Chapter 9
1	Basic Concepts of Bad and Doubtful Debts
2	Measurement of Doubtful Debts
3	Accounting for Bad and Doubtful Debts
4	Increase in Provision for Doubtful Debts
5	Increase in provision continued
6	Decrease in Provision for Doubtful Debts
7	Practice - Specific and General Provision
8	Practice - Provision for Allowable Discount
9	ITTR

Topic 078 – 086 coverd in this chapter.

Basic concept of Bad and Doubtful Debts

Bad Debts are the accounts receivables (Debtors) that an entity will never be able to collect e.g. the customer has gone out of business. These are also known as irrecoverable debts.

Doubtful Debts are the accounts receivables (Debtors) where there is a high risk that it will not be recovered.

Accounting effects for "*bad debts*" and "*doubtful debts*" are different, although both are recognized as expense in the income statement but credit effect is different.

Accounting Entries

1. **Debtors written off as bad debts**

Bad Debts A/c.	Dr	
Debtors' A/c.		Cr

2. **Creating provision for doubtful debts**

Bad Debts A/c.	Dr	
Provision for doubtful debts A/c.		Cr

3. **Increase in provision for doubtful debts**

Bad Debts A/c.	Dr	
Provision for doubtful debts A/c.		Cr

4. **Decrease in provision for doubtful debts**

Provision for doubtful debts A/c.	Dr	
Bad Debts A/c.		Cr

5. **Bad debts recovered**

Bank A/c.	Dr	
Bad Debts Recovered A/c.		Cr

6. **Discount allowed to Debtors.**

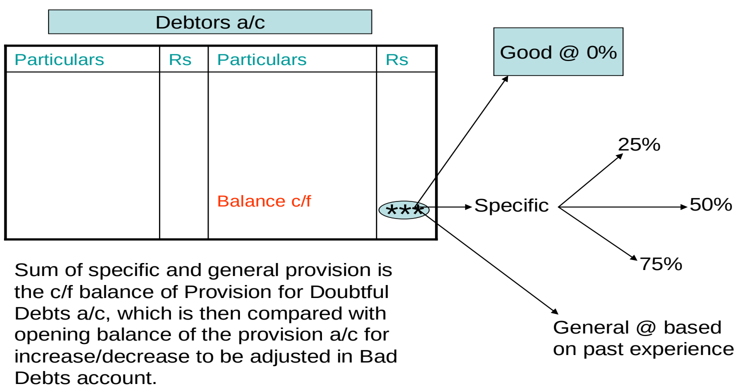
Discount Allowed A/c.	Dr	
Debtors' A/c.		Cr

7. **Creating provision for discount on debts.**

Discount Allowed A/c.	Dr	
Provision for discount A/c.		Cr

Measurement of Doubtful Debts

Provision for doubtful debts based on specifically doubtful debtors:



Practice 9.1 (Specific and general provision)

Closing balance of Debtors is Rs.80,000 out of which:

- one of the debtors Mr. Fill owing Rs.6,000 is also a creditor to whom entity owes Rs.7,500 (he is considered as a good debtor);
- one of the debtors Mr. Kill owing Rs.10,000 is specifically doubtful and 75% is expected recovery from his estate as final dividend;
- one of the debtors Miss Hill owing Rs.6,000 is expected to be doubtful at 50%;
- one of the debtors Mr. Bill owing Rs.8,000 is expected to be doubtful @ 75%;
- Generally, provision for doubtful debts is experienced @ 5% of the debtors' balance.

Calculate provision for doubtful debts against debtors of Rs.80,000 and pass accounting entry for increase in provision assuming that opening balance for provision for doubtful debt at the beginning of reporting period was Rs.10,000.

Answer:	**Rs.**		**Rs.**
Good debtor Mr. Fill	6,000 x 0%	=	zero
Specific debtor			
Mr. Kill	10,000 x 25%	=	2,500
Miss. Hill	6,000 x 50%	=	3,000
Mr. Bill	8,000 x 75%	=	6,000
General debtors (remaining balance; 80,000 – 30,000)	50,000 x 5%	=	2,500
Closing Balance of Debtors	**80,000**		**14,000**

Opening Balance of Provision for Doubtful Debts	**10,000**
Closing Balance of Provision for Doubtful Debts	**14,000**
Increase in Provision for Doubtful Debts	**4,000**

Bad Debts A/c.	Dr 4,000	
Provision for doubtful debts A/c.		Cr 4,000

Provision for doubtful debts based on Aging Analysis:

Closing balance of debtors account is analyzed in terms of age of each customer's outstanding balance. It is worked out that for how long the receivable balance of each customer is overdue, either for number of days or months. Recovery from older balances is considered as a difficult task and hence would be measured at a higher rate to create a provision as doubtful.

Practice 9.2 (Aging analysis)

Analysis of closing balance of debtors shows following facts:

Balance Due:	**Rs.**	**Rate and amount of Provision**		
For less than 30 days	90,000	x	0%	Rs. 0
For more than 30 days but less than 60 days	60,000	x	5%	Rs. 3,000
For more than 60 days but less than 90 days	50,000	x	7%	Rs. 3,500
For more than 90 days	20,000	x	10%	Rs. 2,000
Closing Balance of Debtors and Provision	**220,000**			**Rs. 8,500**

Opening Balance of Provision for Doubtful Debts	**9,800**
Closing Balance of Provision for Doubtful Debts	**8,500**
Decrease in Provision for Doubtful Debts	**1,300**

Provision for doubtful debts A/c.	Dr 1,300	
Bad Debts A/c.		Cr 1,300

Practice 9.3 (Accounting for Bad Debts)

A business has trade receivables of Rs.75,000. Among the debtors' balance, Mr A owes Rs.5,000 to the business who has recently been declared as bankrupt and should be written off.

Debtors / Receivables

	Rs.		Rs.
Bal b/f	75,000	Bad debts	5,000
		Bal c/f	70,000
	75,000		75,000

Bad Debts

	Rs.		Rs.
Debtors	5,000	Profit & Loss – Income Statement	5,000
	5,000		5,000

Debtors written off as bad debts

Bad Debts A/c.	Dr 5,000	
Debtors' A/c.		Cr 5,000

Practice 9.4 (Recognition of provision for doubtful debts)

Year 1

- Trade receivables of Rs.75,000
- Rs.5,000 is to be written off as 'Bad'
- Provision for doubtful debts is to be maintained (for the first time) amounting Rs.2,000

Year 1

Debtors / Receivables

	Rs.		Rs.
Bal b/f	75,000	Bad debts	5,000
		Bal c/f	70,000
	75,000		75,000

Bad Debts

	Rs.		Rs.
Receivables	5,000	Income Statement	7,000
Prov. for Doubtful Debts	2,000		
	7,000		7,000

Provision for doubtful debt

	Rs.		Rs.
Bal c/f	2,000	Bad debts	2,000
	2,000		2,000

Statement of Financial Position

Debtors	70,000
Provision for Doubtful Debts	(2,000)
	68,000

Income Statement

Bad debts expense	7,000

Debtors written off as bad debts

Bad Debts A/c.	Dr 5,000	
Debtors' A/c.		Cr 5,000

Creating provision for doubtful debts

Bad Debts A/c.	Dr 2,000	
Provision for doubtful debts A/c.		Cr 2,000

Practice 9.5 (Recognition of increase in provision for doubtful debts)

Year 2

- Credit sales Rs.200,000
- Receipts from customers Rs.185,000
- Bad debts written off Rs 8,000
- The allowance for doubtful debts is to be increased from Rs.2,000 to Rs.6,000

Year 2

Debtors / Receivables

	Rs.		Rs.
Bal b/f	70,000	Bank	185,000
Sales	200,000	Bad debts	8,000
		Bal c/f	77,000
	270,000		270,000

Bad Debts

	Rs.		Rs.
Debtors	8,000	Income statement	12,000
Provision for Doubtful Debts	4,000		
	12,000		12,000

Provision for Doubtful debt

	Rs.		Rs.
		Bal b/f	2,000
Bal c/f	6,000	Bad debt	4,000
	6,000		6,000

Statement of Financial Position

Debtors	77,000
Provision for Doubtful Debts	(6,000)
	71,000

Income Statement

Bad debts expense	12,000

Debtors written off as bad debts

Bad Debts A/c.	Dr 8,000	
Debtors' A/c.		Cr 8,000

Increase in provision for doubtful debts

Bad Debts A/c.	Dr 4,000	
Provision for doubtful debts A/c.		Cr 4,000

Practice 9.6 (Recognition of decrease in provision for doubtful debts)

Year 3

- Credit sales Rs.200,000
- Receipts from customers Rs.185,000
- Bad debts written off Rs 8,000
- The allowance for doubtful debts is to be decreased from Rs.6,000 to Rs.5,000

Year 3

Debtors / Receivables

	Rs.		Rs.
Bal b/f	70,000	Bank	185,000
Sales	200,000	Bad debts	8,000
		Bal c/f	77,000
	270,000		270,000

Bad Debts

	Rs.		Rs.
Debtors	8,000	Provision for Doubtful Debts	1,000
		Income statement	7,000
	8,000		8,000

Provision for Doubtful debt

	Rs.		Rs.
Bad Debts	1,000	Bal b/f	6,000
Bal c/f	5,000		
	6,000		6,000

Statement of Financial Position

Debtors	77,000
Provision for Doubtful Debts	(5,000)
	72,000

Income Statement

Bad debts expense	7,000

Debtors written off as bad debts

Bad Debts A/c.	Dr 8,000	
Debtors' A/c.		Cr 8,000

Increase in provision for doubtful debts

Provision for doubtful debts A/c.	Dr 1,000	
Bad Debts A/c.		Cr 1,000

Exercise Question 9.7 (Different Scenarios – Maintenance of provision for doubtful debts)

Following information is appearing in a trial balance on reporting date:

	Debit	Credit
Debtors (Closing balance before adjustments)	Rs. 25,000	
Bad debts (written off during the year)	Rs.1,000	
Provision for doubtful debts (opening balance b/f)		Rs. 480

Adjustment Scenario 1

- Write off further bad debts Rs. 500
- Maintain/increase provision for doubtful debts at/up to Rs.600

Adjustment Scenario 2

- Write off further bad debts Rs.500
- Maintain/decrease provision for doubtful debts at/up to Rs.400

Adjustment Scenario 3

- Write off further bad debts Rs. 500
- Increase provision for doubtful debts by Rs.200

Answer Scenario 1

Debtors account

Particulars	Rs.	Particulars	Rs.
From Trial Balance	25,000	Bad Debts (Adjustment)	500
		Balance c/f	24,500
	25,000		25,000

Bad Debts account

Particulars	Rs.	Particulars	Rs.
From Trial Balance	1,000	Income Statement	1,620
Debtors (Adjustment)	500		
Provision for doubtful debts	120		
	1,620		1,620

Provision for doubtful debts account

Particulars	Rs.	Particulars	Rs.
Balance c/f	600	From TB Balance b/f	480
		Bad debts (balancing figure) (Increase in Provision)	120
	600		600

Answer Scenario 2

Debtors account

Particulars	**Rs.**	**Particulars**	**Rs.**
From Trial Balance b/f	25,000	Bad Debts (Adjustment)	500
		Balance c/f	24,500
	25,000		25,000

Bad Debts account

Particulars	**Rs.**	**Particulars**	**Rs.**
From Trial Balance	1,000	Provision for doubtful debts	80
Debtors (Adjustment)	500	Income Statement	1,420
	1,500		1,500

Provision for doubtful debts account

Particulars	**Rs.**	**Particulars**	**Rs.**
Bad debts (balancing figure) (decrease in provision)	80	From TB Balance b/f	480
Balance c/f	400		
	480		**480**

Answer Scenario 3

Debtors account

Particulars	**Rs.**	**Particulars**	**Rs.**
From Trial Balance b/f	25,000	Bad Debts (Adjustment)	500
		Balance c/f	24,500
	25,000		25,000

Bad Debts account

Particulars	**Rs.**	**Particulars**	**Rs.**
From Trial Balance	1,000	Income Statement	1,700
Debtors (Adjustment)	500		
Provision for doubtful debts	200		
	1,700		1,700

Provision for doubtful debts account

Particulars	**Rs.**	**Particulars**	**Rs.**
Balance c/f (balancing figure)	680	From TB Balance b/f	480
		Bad debts (Prov. increase by)	200
	680		680

Exercise Question 9.8

(Specific provision, general provision, increase in provision and decrease in provision)

You are given the following balances on 1st January, 20X9: Debtors Rs. 10,000; Provision for doubtful debts Rs. 400. You ascertain the following information:

Sales for the year 20X9 (all on credit): Rs 100,000; Sales returns for the year 20X9 Rs. 1,000; Collection from debtors during 20X9 Rs. 90,000; Bad debt written off during 20X9 Rs 500; Discount allowed during 20X9 Rs. 400.

At the end of 20X9 the provision for doubtful debts is required to be at 5% of debtors after making a specific provision for a debt of Rs. 200 from a customer who has been declared bankrupt.

Sales for the year 20Y0 Rs. 100,000 (90% on credit); sales return for the year 20Y0 Rs. 2,000 (90% relates to credit customers); Collection from debtors during 20Y0 Rs. 95,000; Debtors balances settled by contra against creditors balances during 20Y0 Rs 3,000; Bad debts written off during 20Y0 Rs. 1,500; Discount allowed during 20Y0 Rs 500. At the end of 20Y0 the provision for doubtful debts is still required to be at 5% of debtors. You are required to write up the Sundry Debtors Account and the Provision for Doubtful Debts Account for the year 20X9 and 20Y0.

Answer

Sundry Debtors A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
1-01-20X9	Balance b/f	10,000	20X9	Sales return	1,000
	Sales	100,000		Collection (Cash/Bank)	90,000
				Bad debts	500
				Discount allowed	400
			Dec 31	Balance c/f	18,100
		110,000			110,000
1-01-20Y0	Balance b/f	18,100	20Y0	Sales return	1,800
	Sales	90,000		Collection (Cash/Bank)	95,000
				Settled by contra	3,000
				Bad debt	1,500
				Discount allowed	500
			Dec 31	Balance c/f	6,300
		108,100			108,100

Provision for Doubtful Debt A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
			1-01-Y1	Balance b/f	400
31-12-X9	Balance c/f (Working*)	1,095		Bad debt (increase in prov)	695
		1,095			1,095
	Bad debts				
	(decrease in provision)	780	1-01-Y2	Balance b/f	1,095
	Balance c/f (6,300 x 5%)	315			
		1,095			1,095

Bad Debts A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
20X9	Debtors	500			
	Provision for Doubtful Debit	695			
	(Increase in provision)			Income Statement	1,195
		1,195			1,195
20Y0	Debtors	1,500		Provision for Doubtful Debt	780
				(Decrease in provision)	
				Income statement	720
		1,500			1,500

***Working:**

18,100

Specific
200 x 100% = 200

General
17,900 x 5% = 895

Total provision = 200 + 895 = 1,095

Exercise Question 9.9, (Provision for Doubtful Debts and Provision for Discount Allowable)

On 1-1-20X9 the Provision for Doubtful Debts Account in the books of S. Zahid stood at Rs. 1,200 and the Provision for Discount Allowable Account at Rs. 150.

On 31-12-20X9, the Sundry Debtors were Rs. 20,400 of which Rs. 400 were considered bad and required to be written off. The discount allowed to Debtors during 20X9 was Rs. 300 (already accounted for).

On 31-12-20Y0, the Sundry Debtors were Rs. 10,100 of which Rs. 100 were considered bad and required to be written off. The discount allowed to debtors during 2010, was Rs. 50 (already accounted for).

On 31-12-20Y1 the Sundry Debtors were Rs.36,200 of which Rs. 200 were considered bad and required to be written off. The discount allowed to debtors during 2011 was Rs. 50 (already accounted for).

It is decided to maintain a provision for doubtful debts at 5% on Sundry Debtors and a provision for discount on debtors at 2% on Debtors.

Show how the provision for Doubtful Debts Account and the provision for Discount Allowable Account would appear in the ledger of S. Zahid for the year 20X9, 20Y0 and 20Y1 bringing down the balance on 1-1-20Y2.

Answer

Debtors A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
20X9	Balance (Reopened)	20,400	20X9	Bad Debt	400
Dec.31			Dec 31	Balance c/f 5%	20,000
		20,400			20,400
20Y0	Balance (Reopened)	10,100	20Y0	Bad Debt	100
Dec.31			Dec.31	Balance. c/f 5%	10,000
		10,100			10,100
20Y1	Balance (Reopened)	36,200	20Y1	Bal Debt	200
Dec.31			Dec.31	Balance c/f 5%	36,000
		36,200			36,200

Provision for Doubtful Debts A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
20X9	Bad Debt		20X9		
Dec.31	(decrease in provision)	200	Jan.1	Balance b/f	1,200
Dec.31	Balance c/f	1,000			
		1,200			1,200
	Bad debt	500	20Y0	Balance b/f	1,000
20Y0	(decrease in provision)		Jan.1		
Dec.31	Balance c/f	500			
		1,000	20Y1		1,000
20Y1			Dec.31	Balance b/f	50
					0
Dec 31	Balance c/f	1,800	Dec.31	Bad debt	1,300
				(Increase in provision)	
		1,800			1,800

Bad Debt A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
20X9			**20X9**		
D.T.Y	Debtors	400	Dec. 31	Provision for Doubtful Debt	200
			Dec. 31	Income Statement	200
		400			400
20Y0			20Y0		
D.T.Y	Debtors	100	Dec. 31	Provision for Doubtful Debt	500
Dec. 31	Income Statement	400			
		500			500
20Y1					
D.T.Y	Debtors	200	20Y1		
Dec. 31	Provision for Doubtful Debt	1,300	Dec. 31	Income statement	1,500
		1,500			1,500

Provision for Discount Allowable A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
20X9			20X9		
			Jan.1	Balance b/f	150
Dec.31	Balance c/f (Working*)	380	Dec.31	Discount allowed (increase in provision)	230
		380			380
20Y0			20Y0		
Dec.31	Discount allowed (decrease in provision)	190	Jan.1	Balance b/f	380
Dec.31	Balance c/f (Working*)	190			
		380			380
			20Y1	Balance b/f	190
	Balance c/f (Working*)	684		Discount allowed (Increase in provision)	494
		684			684

Discount Allowed A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
20X9					
D.T.Y	Debtor (already accounted for)	300	20X9		
Dec.31	Provision for discount allowed	230	Dec.31	Income statement	530
		530			530
20Y0			20Y0		
D.T.Y	Debtor (already accounted for)	50	Dec.31	Provision for discount allowed	190
Dec.31	Income statement	140			
		190			190
20Y1					
D.T.Y	Debtor (already accounted for)	50	20Y1		
Dec.31	Provision for discount allowed	494	Dec.31	Income statement	544
		544			544

***Workings:**

	Year 20X9	**Year 20Y0**	**Year 20Y1**
Debtors c/f	20,000	10,000	36,000
Provision for doubtful debts c/f	(1,000)	(500)	(1,800)
	19,000 x 2%	9,500x2%	34,200x2%
	= 380	= 190	= 684

Examination Question 9.10

(First dividend, Final dividend from bankrupt debtors)
Because of their doubtful nature, Saqib Ulfat instructed his accountant to make a specific provision in the account for the year ended 31st December, 20Y0 against the following debts:

Shams Rs. 280 Dawood Rs. 60 Tauqeer Rs. 240 Shahzad Rs. 2,040

He also instructed that a general provision of 5% for doubtful debts should be created on the other debtors, which at 31st December, 20Y0 amounted to Rs. 80,000.
No further business transaction was entered into with any of these debtors during the year ended 31st December, 20Y1 but an amount of Rs. 90 was received from Shams trustee in bankruptcy by way of a first dividend; a first and final dividend of Rs. 700 was received from the liquidator of Shahzad, whereas Tauqeer paid his debt in full. A further debt of Rs. 950 due form Sajid Anwar proved to be bad.
On 31st December, 20Y1 Saqib Ulfat instructed his accountants to maintain the provision existing against Dawood's debt and to fully provide for the balance due from Shams, whereas create further provision for doubtful debts due form Bobby Rs 190 and Asad Ali Rs 150. The other debtors amounted to Rs. 75,000 for which the accountant was instructed to create a general provision for doubtful debts equal to 5%.
Prepare Bad Debts Account and Provision for Doubtful Debts Account.

Answer

Provision for Doubtful Debt A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
	Bad debts (decrease in prov.)	2,280	01-01-Y1	Balance b/f (Working*)	6,620
31-12-Y1	Balance c/f (Working*)	4,340			
		6,620			6,620

Bad Debt A/c.

Date	Particular	Rs.	Date	Particulars	Rs.
20Y0	Debtors (Working*)	2,290		Provision for D. Debt	2,280
				Income Statement	10
		2,290			2,290

***Workings:**

Opening Provision balance on 01.01.Y1	Rs.	Closing Provision balance on 31.12.Y1	Rs.
Shams	280	Dawood	60
Dawood	60	Shams (280-90)	190
Tauqeer	240	Bobby	190
Shahzad	2,040	Asad Ali	150
General (80,000x5%)	4,000	General (75,000x5%)	3,750
	6,620		4,340

Bad Debts

	Rs.
Shahzad (2,040-700)	1,340
Sajid Anwar	950
	2,290

Important Tips To Remember (ITTRs)

1. Debtors are not written off with the amount of doubtful debts.
2. Doubtful debts are credited in an account:
   - known as a provision/allowances for doubtful debts
   - this provision is set off against the debtors' balance on the face of Statement of Financial Position (balance sheet).
   - credit balance of the provision account represents specifically doubtful receivables and/or general receivables. At the end of reporting period, there could be a valid reason to believe that there is no doubt with regards to recovery from specific debtors but based on past experience few unidentified debtors might become bad, for which provision is created for general debtors.
3. Credit balance on provision account is re-measured at each reporting date (balance sheet date).
   - If the required (remeasured) balance is greater than the previous balance, then an additional expense is recognised as bad debts with the incremental amount.
   - If the required (remeasured) balance is lesser than the previous balance, then the amount of reduction in balance would also reduce the bad debts expense for the period.
4. Amount for the bad debts expense chargeable to the Income Statement is worked out as below:
   - Bad debts written-off during the reporting period
   - Add increase in Provision for doubtful debt or
   - Less decrease in Provision for doubtful debt
   - Less Bad debts recovered during the reporting period
5. Amount for the discount allowed expense chargeable to the Income Statement is worked out as below:
   - Actual discount allowed during the reporting period
   - Add provision created for discounts allowable
6. Presentation in Statement of Financial Position / Balance Sheet
   - Debit balance of Debtors account and credit balance of Provision for Doubtful Debts account are set off in the Statement of Financial Position
   - Provision for discount allowable is calculated on remaining debtors balance after subtracting credit balance of provision for doubtful debts from the debtors' balance.
   - Provision for discount allowable is subtracted from the debtors after subtracting the closing balance of provision for doubtful debts.
7. Bad debts appearing in Dr side of Trial Balance are not subtracted from Debtors balance appearing in Dr side of Trial Balance; because these have already been accounted for.

1. At 1 July 20X5, a company's provision for doubtful debts was Rs.48,000. At 30 June 20X6, trade receivables amounted to Rs.838,000. It was decided to write off Rs.72,000 of these debts as bad and adjust the provision for doubtful debts to Rs.60,000.

What are the final amounts for inclusion in the company's statement of financial position at 30 June 20X6?

	Trade Receivables	Provision for doubtful debts	Net balance of Trade Receivables
	Rs.	Rs.	Rs.
A.	838,000	60,000	778,000
B.	**766,000**	**60,000**	**706,000**
C.	766,000	108,000	658,000
D.	838,000	108,000	730,000

Trade receivables 838,000 less 72,000 bad debts written off = 766,000
Closing balance of provision for doubtful debts appears in SoFP = 60,000
Net Balance of Trade Receivables 766,000 – 60,000 = 706,000

2. The sales revenue in a company was Rs.2 million and its debtors were 5% of sales. The company wishes to have a provision for doubtful debts of 4% of debtors' balance, which would make the allowance one-third higher than the opening balance of the provision.

How will the profit for the period be affected by the change in allowance?

A. **Profit will be reduced by $1,000**
B. Profit will be increased by $1,000
C. Profit will be reduced by $1,333
D. Profit will be increased by $1,333

Debtors = 2,000,000 x 5%	**= 100,000**
Provision closing balance	**= 100,000 x 4% = 4,000**
Opening balance of provision	**= 4,000 x ¾ = 3,000**
Increase in provision	**= 4,000 – 3,000 = 1,000**

3. **An increase in the provision for doubtful debts results in:**

A. an increase in net current assets
B. a decrease in net current assets
C. a decrease in current liabilities
D. an increase in current liabilities

Provision for doubtful debts balance is subtracted from Debtors balance which ultimately causes a decrease in current assets balances.

4. At the end of the year 20X7, Cheema's receivable's balance is Rs. 230,000. He wishes to make specific provision for Emely's debt of Rs.450 and Lala's debt of Rs.980. He also wishes to maintain a general provision of 5% for receivables/debtors.

What amount would be charged or credited to the income statement in respect of the provision if the balance of provision at the start of the year was Rs.11,700?

- **A. Rs.1,159 Dr**
- **B.** Rs.1,230 Dr
- **C.** Rs.200 Cr
- **D.** Rs.12,930 Dr

General Provision = 230,000 – 450 – 980 = 11,428.5 say 11,429 (rounding up)
Closing balance of provision = 11,429 + 450 + 980 = 12,859
Opening balance of provision = 11,700
Increase in provision to be charged I/S = 12,859 – 11,700 = 1,159.

5. In the statement of financial position at 31 December 20X5, Babar reported gross receivables of Rs.12,000. During 20X6 he made sales on credit of Rs.125,000 and received cash from credit customers amounting to Rs.115,500. At 31 December 20X6, Babar decided to write off debts of Rs.7,100 and increased the allowance for doubtful receivables by Rs.950 to Rs.2,100.

What is the net receivables figure at 31 December 20X6?

- **A. Rs.12,300**
- **B.** Rs.13,450
- **C.** Rs.14,400
- **D.** Rs.15,550

(12,000 + 125,000 – 115,500 – 7,100) – (2,100)
Subtract closing balance of provision from the closing balance of receivables.
No need to bother about the opening balance of allowance for doubtful debts.

6. At 30 April 20X7 the total amount owed to Jamal by his customers was Rs.54,864. At the same date, Jamal calculated that his doubtful debts' allowance is Rs.3,775.

How should these balances be reported in Jamal's balance sheet?

- **A. Rs.51,089 as a current asset**
- **B.** Rs.51,089 as a current liability
- **C.** Rs.54,864 as a current asset, and $3,775 as a current liability
- **D.** Rs.54,864 as a current liability, and $3,775 as a current asset

7. Dr. Waseem's trial balance at 30 September 20X5 includes the following balances:

Trade receivables	Rs.75,943
Doubtful debts allowance	Rs.4,751

How should these balances be reported in Dr. Waseem's balance sheet as at 30 September 2005?

A. A liability of Rs.71,192
B. An asset of Rs.75,943 and a liability of Rs.4,751
C. **An asset of Rs.71,192**
D. A liability of Rs.75,943 and an asset of Rs.4,751

Doubtful debts allowance/provision is subtracted from the Debtors' balance, net Debtors' balance is presented in the balance sheet as asset.

8. Zohra calculated that her receivables allowance at 30 April 20X7 should be Rs.890. At 30 April 20X6, her receivables allowance was Rs.770.

How should the movement in the receivables allowance be recorded in Zohra's income statement?

A. a charge of Rs.890
B. **a charge of Rs.120**
C. a credit of Rs.890
D. a credit of Rs.120

Receivable allowance is provision for doubtful debts, an increase in provision is charged to income statement as expense.

CHAPTER - 10

ACCOUNTING FOR FIXED ASSETS
AND DEPRECIATION

Sr. No	Course Outline Topics
1	Basic Definition and Concept
2	Depreciation Methods and Depreciation Rates
3	Basic Depreciation Accounting
4	Disposal of Fixed Assets - Accounting Entries
5	Disposal of Fixed Assets - at the beginning of the year (for Loss)
6	Disposal of Fixed Assets - at the beginning of the year (for Gain)
7	Disposal of Fixed Assets - during the year – (for Loss)
8	Disposal of Fixed Assets - during the year – (for Gain)
9	Exchange of Asset

Topic videos 87-95 are mandatory part of this module

Basic Definitions and Concepts

Property Plant and Equipment

- These are asset that will be used over a period of time (in excess of one year)
- These are not held for re-sale in the normal course of trading
- These may be held for:
  - Production of goods or services
  - Selling of goods or services
  - Administrative purposes
  - Rental to others

Recognition Criteria

- Cost can be measured reliably
- Probability of inflow of economic benefits in future

Measurement

- At recognition
  - Purchased constructed/manufactured assets are initially measured at cost
  - Exchanged assets are initially measured at fair value, unless:
    - The exchange transaction lacks commercial substance or
    - Fair value cannot be determined, in these circumstances; carrying amount of the asset given up will be the value of the asset taken in exchange.

After recognition

- After once recognized the items of property, plant and equipment are measured at either of the two models:
  - Cost model
    - Cost of asset less accumulated depreciation less accumulated impairment loss
  - Revaluation model **(not in syllabus)**
    - Revalued amount less accumulated depreciation subsequent to revaluation and accumulated impairment loss subsequent to revaluation.

Cost components

- Purchase price less trade discounts and rebates
- Import duties
- Non-refundable purchase taxes
- Directly attributable cost
- Estimated cost of dismantling, removal and site restoration

Directly attributable cost is the cost that is incurred to bring the asset into a condition, which is necessary for it to be capable of use as intended by management of entity.

Impairment loss **(not in syllabus)**

- When carrying amount of asset is greater than its recoverable amount the difference is Impairment Loss.

Depreciation

- Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life

Depreciable amount

- Cost of an asset, or other amount substituted for cost, less its residual value

Useful life

- Period over which an asset is expected to be used; or
- Number of production units expected to be obtained from the asset

Depreciation rate is determined based on useful life and residual value of the asset.

Depreciation methods

- Straight line method
- Reducing balance method
- Sum of years digit method
- Number of units output method
- Number of service hours method

Selection of depreciation method depends upon pattern of economic benefits of the asset to the entity.

Practice 10.1 (Depreciation Methods / Depreciation Rates)

Machine bought on 1.1.20X9 for Rs.80,000. Its residual value is estimated Rs.2,000 with 4 years useful life. It can work for 12,000 hours in total and can produce 40,000 units in total (as per estimate)

Following is its actual results in 20X9 and 20Y0

Year	Service Hours	Units Produced
20X9	2,000	7,000
20Y0	5,000	15,000

Calculate depreciation for two years using each of the following methods:

1. Straight line method
2. Reducing balance method
3. Service hour method
4. Units output/produced method
5. Sum of years' digit method

Answer:

	Rs.
Cost of Machine	80,000
Less Residual value	(2,000)
Depreciable amount	**78,000**

1. Straight Line Method

$$\frac{\text{Depreciable Amount}}{\text{useful Life}} = \text{Depreciation}$$

$$\frac{78,000}{4} = 19500$$

	Year 20X9	Rs. 19,500
78,000 x 25%	Year 20Y0	Rs. 19,500

2. Reducing Balance Method

$$\left(1 - \sqrt[n]{\frac{\text{Residual Value}}{\text{Cost}}}\right) \times 100 = \%$$

Where n = useful life

$$\left(1 - \sqrt[4]{\frac{2,000}{80,000}}\right) \times 100 = 60\%$$

Year 20X9	80,000 x 60%	Rs. 48,000
Year 20Y0	32,000 x 60%	Rs. 19,200

Under reducing balance method first year's depreciation is calculated by applying depreciation rate on cost, whereas in subsequent years depreciation is calculated by applying depreciation rate on opening balance of Net Book Value (NBV).

3. Service Hours Method/Usage method

$$\frac{\text{Depreciable Amount}}{\text{Total Estimated Hours}} = \text{Depreciation Rate Per Hour}$$

$$\frac{78{,}000}{12{,}000} = Rs. 6.50\,Per Hour$$

Year 20X9	2,000 x 6.50	Rs. 13,000
Year 20Y0	5,000 x 6.50	Rs. 32,500

4. Units Output/Production Method

$$\frac{\text{Depreciable Amount}}{\text{Total Estimated Output}} = \text{Depreciation Rate Per Unit}$$

$$\frac{78{,}000}{40{,}000} = Rs. 1.95\,Per Unit$$

Year 20X9	7,000 x 1.95	Rs. 13,650
Year 20Y0	15,000 x 1.95	Rs. 29,250

5. Sum of Years' Digit Method

	Year			Rs.
20X9	1	78,000 x 4/10	=	31,200
20Y0	2	78,000 x 3/10	=	23,400
20Y1	3	78,000 x 2/10	=	15,600
20Y2	4	78,000 x 1/10	=	7,800

Sum of years 1 + 2 + 3 + 4 = 10. In the year 20X9 i.e. first year the Machine is expected to be used for 4 year, in second year the Machine is expected to be used for 3 years, in third year the Machine is expected to be used for next 2 years and in last year the Machine is expected to be used in the current year only.

Basic Accounting for Depreciation

Accounting Entries

1. Fixed Asset A/c.
   Cash/Bank/Creditor A/c.
   (Purchase of Fixed Asset upon payment or on credit)

2. Depreciation Expense A/c.
   Provision for Depreciation A/c.
   (Provision against depreciation expense for the year)

3. Profit & Loss A/c.
   Depreciation Expense A/c.
   (Depreciation expense closed to Income Statement)

Practice 10.2 (Basic Depreciation Accounting)

20X9		*Rs.*
January 1,	Opening balance Plant and Machinery	25,000
January 1,	Opening Balance Accumulated Depreciation	10,000
July 1,	Purchased New Plant	20,000

Required: Prepare Plant and Machinery Account and Provision for Depreciation Account for the year ending on December 31, 20X9 assuming the following scenarios:

I

Depreciation method	Reducing Balance Method
Depreciation rate	10%
Depreciation basis	Full year depreciation in the year of purchase

II

Depreciation method	Reducing Balance Method
Depreciation rate	10%
Depreciation basis	Time proportionate

III

Depreciation method	Straight Line Method
Depreciation rate	10%
Depreciation basis	Full year depreciation in the year of purchase

IV

Depreciation method	Straight Line Method
Depreciation rate	10%
Depreciation basis	Time proportionate

Answer:

Scenario 1 (Reducing balance method – Full year depreciation)

Plant and Machinery account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Jan 1 Balance b/f	25,000	Dec 31 Balance c/f	45,000
July 1 Bank	20,000		
	45,000		**45,000**

Provision for Depreciation

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Dec 31 Balance c/f	13,500	Jan 1 Balance b/f	10,000
		Dec 31 Depreciation Expense	3,500
	13,500		**13,500**

Depreciation charge = (opening NBV x rate) 25,000 – 10,000 = 15,000 x10%	Rs. 1,500
20,000 X 10% Fully Year	Rs. 2,000
	3,500

Scenario 2
(Reducing balance method – Time proportionate depreciation)

Plant and Machinery account

Particulars	**Rs.**	**Particulars**	**Rs.**
20X9		**20X9**	
Jan 1 Balance b/f	25,000	Dec 31 Balance c/f	45,000
July 1 Bank	20,000		
	45,000		**45,000**

Provision for Depreciation

Particulars	**Rs.**	**Particulars**	**Rs.**
20X9		**20X9**	
Dec 31 Balance c/f	12,500	Jan 1 Balance b/f	10,000
		Dec 31 Depreciation Expense	2,500
	12,500		**12,500**

		Rs.
Depreciation charge (opening NBV x rate)	25,000 – 10,000 = 15,000 x10%	1,500
New Machine	20,000 x 10% x 6/12	1,000
		2,500

Scenario 3
(Straight Line Method – full year depreciation)

Plant and Machinery account

Particulars	**Rs.**	**Particulars**	**Rs.**
20X9		**20X9**	
Jan 1 Balance b/f	25,000	Dec 31 Balance c/f	45,000
July 1 Bank	20,000		
	45,000		**45,000**

Provision for Depreciation

Particulars	**Rs.**	**Particulars**	**Rs.**
20X9		**20X9**	
Dec 31 Balance c/f	14,500	Jan 1 Balance b/f	10,000
		Dec 31 Depreciation Expense	4,500
	14,500		**14,500**

Depreciation charge = (Closing cost x rate) 45,000 x10% = **Rs. 4,500**

Scenario 4
(Straight Line Method – Time proportionate depreciation)

Plant and Machinery account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Jan 1 Balance b/f	25,000	Dec 31 Balance c/f	45,000
July 1 Bank	20,000		
	45,000		**45,000**

Provision for Depreciation

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Dec 31 Balance c/f	13,500	Jan 1 Balance b/f	10,000
		Dec 31 Depreciation Expense	3,500
	13,500		**13,500**

		Rs.
Depreciation charge = (opening cost x rate)	25,000 x10%	2,500
New Machine	20,000 x10% x 6/12	1,000
		3,500

Accounting Entries for Disposal of Fixed Asset

1. Asset Disposal A/c.
   Fixed Asset A/c.
   (Asset transferred to asset disposal account, with the amount of gross carrying amount / cost of asset)

2. Provision for Depreciation A/c.
   Asset Disposal A/c.
   (Accumulated depreciation balance till the date of disposal transferred to asset disposal account)

3. Bank A/c.
   Asset Disposal A/c.
   (Disposal Consideration / sales proceeds received on disposal of the asset)

4.
   a) Asset Disposal A/c.
      Income Statement
      (Profit/Gain on disposal of asset transferred to income statement for the period)

   b) Income Statement
      Asset Disposal A/c.
      (Loss on disposal of asset transferred to income statement for the period)

Exercise Question 10.3

Scenario 1

(Disposal of fixed assets at the beginning of year – for loss)

On Jan. 1 20X9 machine costing Rs.70,000 and accumulated depreciation being Rs.50,000 was sold for Rs.15,000 on Jan 1 20X9.

Machine Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Jan 1 Balance b/f	70,000	Jan 1 Disposal a/c	70,000
		Balance c/f	Nil
	70,000		**70,000**

Provision for Depreciation Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Jan 1 Disposal a/c	50,000	Jan 1 Balance b/f	50,000
Balance c/f	Nil		
	50,000		**50,000**

Asset Disposal Account

Particulars	Rs	Particulars	Rs
20X9		**20X9**	
Jan 1 Machine a/c	70,000	Jan 1 Provision for depreciation	50,000
		Jan 1 Cash a/c	15,000
		Dec 31 Income Statement (Loss)	5,000
	70,000		**70,000**

Scenario 2

(Disposal of fixed assets at the beginning of year – for gain)

On Jan 1 20X9 machine costing Rs.70,000 and accumulated depreciation being Rs.50,000 was sold for Rs.22,000 on Jan 1 20X9.

Machine Account

Particulars	Rs	Particulars	Rs
20X9		**20X9**	
Jan 1 Balance b/f	70,000	Jan 1 Disposal a/c	70,000
		Balance c/f	Nil
	70,000		**70,000**

Provision for Depreciation Account

Particulars	Rs.	Particulars	Rs.
2009		**20X9**	
Jan.1 Disposal a/c	50,000	Jan 1 Balance b/f	50,000
Balance c/f	Nil		
	50,000		**50,000**

Asset Disposal account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Jan. 1 Machine a/c	70,000	Jan 1 Provision for depreciation	50,000
Dec.31 Income Statement (Profit)	2,000	Jan 1 Cash a/c	22,000
	72,000		**72,000**

Scenario 3
(Disposal of fixed assets during the year – for loss)

On Jan 1 20X9 machine costing Rs.70,000 and accumulated depreciation being Rs.50,000 was sold for Rs.15,000 on June 30 20X9. The above machine was depreciated at 10% on reducing balance method.

Machine Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Jan 1 Balance b/f	70,000	June 30 Disposal a/c.	70,000
		Balance c/f	Nil
	70,000		**70,000**

Provision for Depreciation Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
June 30 Disposal a/c.	51,000	Jan 1 Balance b/f	50,000
Balance c/f	Nil	June 30 Depreciation expense	1,000
	51,000		**51,000**

Asset Disposal Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
June 30 Machine a/c.	70,000	June 30 Provision for depreciation	51,000
		June 30 Cash a/c.	15,000
		Dec 31 Income Statement (Loss)	4,000
	70,000		**70,000**

Depreciation Expense Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
June 30 Provision for Dep.	1,000	Dec 31 Income Statement	1,000
	1,000		**1,000**

*** Working:**

Cost	70,000	
Less Accumulated Depreciation	50,000	
NBV	20,000	$\times 10\% = 2{,}000 \times \frac{6}{12} = 1{,}000$

Scenario 4

On Jan 1 20X9 machine costing Rs.70,000 accumulated depreciation being Rs.50,000 was sold for Rs.22,000 on June 30 20X9. The above machine was depreciated at 10% on Straight line Method.

Machine Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Jan 1 Balance b/f	70,000	June 30 Disposal a/c	70,000
		Balance c/f	NIL
	70,000		**70,000**

Provision for Depreciation Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
June 30 Disposal	53,500	Jan 1 Balance b/f	50,000
Balance c/f	NIL	June 30 Depreciation Expense*	3,500
	53,500		**53,500**

Asset Disposal Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
June 30 Machine a/c	70,000	June 30 Provision for depreciation	53,500
Dec.31 Income Statement (Profit)	5,500	June 30 Cash A/c	22,000
	75,000		**75,500**

Depreciation Expense Account

Particulars	Rs	Particulars	Rs
20X9		**20X9**	
June 30 Provision for Dep	3,500	Dec 31 Income Statement	3,500
	3,500		**3,500**

*** Working:**

Cost 70,000 $\times 10\% = 7{,}000 \times \frac{6}{12} = 3{,}500$

Exercise Question 10.4
(Disposal and Addition of fixed assets during the year)

20X9		***Rs.***
January 1,	Opening Balance Plant and Machinery	25,000
January 1,	Opening Balance Accumulated Depreciation	10,000
July 1,	Old plant disposed of costing	5,000
	Provision for depreciation of the old plant on 1-1-X9	2,000
July 1,	Purchased New Plant	20,000
	Disposal proceeds	2,500

Required: Prepare Plant and Machinery Account, Provision for Depreciation Account and Asset Disposal Account for the year ending on December 31, 20X9 assuming the following scenarios:

1.

Depreciation method	Straight Line Method
Depreciation rate	10%
Depreciation basis	Full year depreciation in the year of purchase and no depreciation in the year of disposal.

2.

Depreciation method	Straight Line Method
Depreciation rate	10%
Depreciation basis	Time proportionate

3.

Depreciation method	Reducing Balance Method
Depreciation rate	10%
Depreciation basis	Full year depreciation in the year of purchase and no depreciation in the year of disposal.

4.

Depreciation method	Reducing Balance Method
Depreciation rate	10%
Depreciation basis	Time proportionate

Answer:

Scenario 1

Plant and Machinery account

Particulars	Rs	Particulars	Rs
20X9		**20X9**	
Jan 1 Balance b/f	25,000	July 1 Disposal a/c	5,000
July 1 Bank	20,000	Dec 31 Balance c/f	40,000
	45,000		**45,000**

Provision for Depreciation account

Particulars	Rs	Particulars	Rs
20X9		**20X9**	
July 1 Disposal a/c	2,000	Jan 1 Balance b/f	10,000
Dec 31 Balance c/f	12,000	Dec 31 Depreciation Expense	4,000
	14,000		**14,000**

Machine Disposal account

Particulars	Rs	Particulars	Rs
20X9		**20X9**	
July 1 Plant & Machine	5,000	July 1 Provision for dep a/c	2,000
		July 1 Bank	2,500
		Dec 31 Income Statement	500
	5,000		**5,000**

Depreciation Charge for Asset used during the reporting period (SLM – Full Year Basis)

	Cost Rs.
Opening balance b/f	25,000
Opening balance Disposed off	(5,000)
Opening balance in use for full year	**20,000**
Opening balance Cost 20,000 x 10%	2,000
New Machine 20,000 x 10%	2,000
Depreciation charge for the year	**4,000**

Scenario 2

Plant and Machinery Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Jan 1 Balance b/f	25,000	July 1 Disposal a/c	5,000
July 1 Bank	20,000	Dec 31 Balance c/f	40,000
	45,000		**45,000**

Provision for Depreciation account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
July 1 Disposal a/c	2,250	Jan 1 Balance b/f	10,000
Dec 31 Balance c/f	11,000	July 1 Depreciation Expense	250
		Dec 31 Depreciation Expense	3,000
	13,250		**13,250**

Machine Disposal account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
July 1 Plant & Machine	5,000	July 1 Provision for dep a/c	2,250
		July 1 Bank	2,500
		Dec 31 Income Statement	250
	5,000		**5,000**

Depreciation Charge for Assets in use on reporting date (SLM – Time proportion Basis)

	Cost Rs.
Opening balance b/f	25,000
Opening balance Disposed of	(5,000)
Opening balance in use for full year	**20,000**
Opening balance Cost 20,000 x 10%	2,000
New Machine 20,000 x 10% x 6/12	1,000
Depreciation charge for the year	**3,000**

Depreciation Charge of Asset sold during the year

Opening balance cost of asset sold during the year 5,000 x 10% x 6/12 = **250**

Accumulated depreciation of asset sold till the date of disposal = 2,000 + 250 = **2,250**

Scenario 3

Plant and Machinery Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
Jan 1 Balance b/f	25,000	July 1 Disposal a/c	5,000
July 1 Bank	20,000	Dec 31 Balance c/f	40,000
	45,000		**45,000**

Provision for Depreciation Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
July 1 Disposal A/c.	2,000	Jan 1 Balance b/f	10,000
Dec 31 Balance c/f	11,200	Dec 31 Depreciation Expense	3,200
	13,200		**13,200**

Machine Disposal Account

Particulars	Rs.	Particulars	Rs.
20X9		**20X9**	
July 1 Plant & Machine	5,000	July 1 Provision for dep a/c	2,000
		July 1 Bank	2,500
		Dec 31 Income Statement	500
	5,000		**5,000**

Depreciation Charge for Asset used during the reporting period (RBM – Full Year Basis)

	Cost	**Accumulated Depreciation**	**NBV**
	Rs.	**Rs.**	**Rs.**
Opening balance b/f	25,000	10,000	15,000
Opening balance Disposed of	(5,000)	(2,000)	(3,000)
Opening balance in use for full year	**20,000**	**8,000**	12,000

		Rs.
Opening balance NBV 12,000 x 10%	=	1,200
New Machine 20,000 x 10%	=	2,000
Depreciation charge for the year		**3,200**

Scenario 4

Plant and Machinery account

Particulars	Rs	Particulars	Rs
20X9		**20X9**	
Jan 1 Balance b/f	25,000	July 1 Disposal a/c	5,000
July 1 Bank	20,000	Dec 31 Balance c/f	40,000
	45,000		**45,000**

Provision for Depreciation Account

Particulars	Rs	Particulars	Rs
20X9		**20X9**	
July 1 Disposal a/c	2,150	Jan 1 Balance b/f	10,000
Dec 31 Balance c/f	10,200	July 1 Dep Expense	150
		Dec 31 Dep Expense	2,200
	12,350		**12,350**

Machine Disposal Account

Particulars	Rs	Particulars	Rs
20X9		**20X9**	
July 1 Plant & Machine	5,000	July 1 Provision for dep. a/c.	2,150
		July 1 Bank	2,500
		Dec 31 Income Statement	350
	5,000		**5,000**

Depreciation Charge for Assets in use on reporting date (RBM – Time proportion Basis)

	Cost	**Accumulated Depreciation**	**NBV**
	Rs.	**Rs.**	**Rs.**
Opening balance b/f	25,000	10,000	15,000
Opening balance Disposed off	(5,000)	(2,000)	(3,000)
Opening balance in use for full year	**20,000**	**8,000**	**12,000**

		Rs.
Opening balance NBV 12,000 x 10%	=	1,200
New Machine 20,000 x 10% x 6/12	=	1,000
Depreciation charge for the year		**2,200**

Depreciation Charge for Asset sold during the year

Opening NBV balance of asset sold during the year 3,000 x 10% x 6/12 = **150**

Accumulated depreciation of asset sold till the date of disposal = 2,000 + 150 = **2,150**

Exchange of Asset

Exchange of Asset – Trade-in-Allowance

When an old asset is exchanged with a new asset the seller of new asset will offer an allowance while receiving payment for selling asset in consideration of the exchange of old asset. Such allowance is known as “trade in allowance”. The buyer will subtract “trade in allowance” from the cost of new asset while making payment to the seller.

Cost of new asset = Cash consideration + Trade in allowance.

Cost of new asset – trade in allowance = Cash consideration

Asset account will be debited with the cost of new asset i.e., cash paid plus trade in allowance.

Trade in allowance is considered as disposal proceeds of the old asset.

Exchange of Asset – Commercial Substance

When an asset is exchanged with another asset and commercial substance does not exist in such exchange, the cost of asset taken through exchange is carrying amount of asset given up.

But when the commercial substance does exist, then cost of asset taken through exchange would be fair value of asset given up.

When fair value of both assets is not determinable the carrying amount of asset given up would be considered as cost of asset taken through exchange.

Existence of commercial substance means; that the entity specific values (present value of future expected cash flows) of both assets are not equal.

Important Tips to Remember (ITTRs)

1. Final balance of depreciation expense a/c is closed into the income statement as expense.

2. Carried forward balance of provision for depreciation is subtracted from carried forward balance of fixed asset to get net book value, which is shown in Statement of Financial Position.

3. While calculating depreciation charge for the year, following information must be gathered first.

a.	Depreciation rate	10% or 5% etc.
b.	Deprecation method	SLM or RBM etc.
c.	Deprecation basis	Time Proportionate or Full Year Basis etc.

4. Where date of purchase/disposal is given always use time proportionate basis if question is silent regarding the basis. But where the date of purchase and disposal are not given and the question is silent regarding the basis then charge full year's depreciation in the year of purchase and no deprecation in the year of disposal.

5. While calculating depreciation charge under straight line method subtract residual value from cost of the asset and then apply depreciation rate. This process will be followed in each year of useful life. In case the residual value is nil then depreciation rate will be applied on original cost in each year of its useful life. That is why straight line method is also named as original cost method.

6. While calculating depreciation charge under reducing balance method, in first year of useful life, depreciation rate is applied on cost, whereas in subsequent years depreciation rate is applied on opening balance of net book value of the asset for full year assuming there is no addition during the year.

7. In the year of disposal, depreciation charge will be calculated from opening date till the date of disposal and accounting entry will be:

Depreciation expense	Dr.	
Provision for depreciation		Cr.

This accounting entry (for such amount) shall be recorded in order to complete accumulated depreciation till the date of disposal.

Remember: The above accounting effect shall be made if and only if time proportionate basis is being followed.

8. While recording accounting entries for disposal of fixed asset, follow the following steps:

   a. Identify/calculate the amount of accumulated depreciation till the date of disposal in accordance with depreciation basis and then pass the accounting entry to transfer accumulated depreciation into asset disposal account.

   b. Transfer cost of asset sold/disposed into asset disposal account.

   c. Whether the asset is sold for cash credit or claim for insurance is lodged, the amount will be considered as disposal proceeds and will be credited in disposal account.

9. Single accounting entry for disposal of assets:

Provision for depreciation A/c.	Dr.	
Cash/Bank/Insurance claim A/c.	Dr.	
Income statement (for loss - if any)	Dr.	
Fixed Asset A/c.		Cr.
Income statement (For gain - if any)		Cr.

10. When an old asset is exchanged with a new asset the seller of new asset will offer an allowance while receiving payment for selling asset in consideration of the exchange of old asset. Such allowance is known as "trade in allowance". The buyer will subtract "trade in allowance" from the cost of new asset while making payment to the seller.
Cost of new asset = Cash consideration + Trade in allowance.
Cost of new asset – trade in allowance = Cash consideration

11. Asset account will be debited with the cost of new asset i.e., cash paid plus trade in allowance.

12. Trade in allowance is considered as disposal proceeds of the old asset.

13. Whenever the rate of deprecation, useful life of asset, depreciation method and/or residual value of asset is changed, accounting effects of such changes shall be recognized prospectively i.e. in the current year and subsequent years.

14. When an asset is exchanged with another asset and commercial substance does not exist in such exchange, the cost of asset taken through exchange is <u>carrying amount of asset given up.</u>

    But when the commercial substance does exist, then cost of asset taken through exchange would be <u>fair value of asset given up</u>. When fair value of both assets is not determinable the <u>carrying amount of asset given up</u> would be considered as cost of asset taken through exchange.

15. Existence of commercial substance means; that the entity specific value (present value of future expected cash flows) of both assets are not equal.

MCQs

1. Bashir acquired a Motor Van on 1 May 20X3 at cost of Rs.30,000. The Motor Van has an estimated useful life of four years, and an estimated residual value of Rs.6,000.

Bashir charges depreciation on the straight-line basis, with a proportionate charge in the period of acquisition.

What will the depreciation charge for the Motor Van be in B's accounting period to 30 September 20X3?

- **A.** Rs.3,000
- **B.** **Rs.2,500**
- **C.** Rs.2,000
- **D.** Rs.5,000

30,000 – 6,000 = 24,000/4years = 6,000 x 5/12 months = 2,500 for the proportionate period of five months

2. A non-current asset was disposed of for Rs.2,200 during the last accounting year. It had been purchased exactly three years earlier for Rs.5,000, with an estimated residual value of $500, and had been depreciated on the reducing balance basis, at 20% per annum.

The gain or loss on disposal was:

- **A.** **Rs.360 loss**
- **B.** Rs.150 loss
- **C.** Rs.104 loss
- **D.** Rs.200 profit

(Net book value = 5,000 – 1,000 – 800 – 640 = 2,560) – (Disposal proceed 2,200) = Loss 360
Residual value is not subtracted while calculating depreciation on reducing balance method.

The following information relates to the next three questions:

An equipment which had cost of Rs.20,000 and had accumulated depreciation of Rs.17,200 was sold during 20X7 for Rs.4,800. The total cost of machinery shown in the December 20X6 statements of financial positions was Rs.180,000 and the related accumulated depreciation was Rs.92,000. The company uses 10% straight-line depreciation on machinery and no depreciation is charged in the year in which an asset is sold.

3. **What is the balance on the accumulated depreciation account at 31/12/20X7?**

Rs. ____________________90,800

(92,000 – 17,200 + 16,000 [160,000 x 10%])

4. **What is the gain or loss on disposal of the equipment?**

- **A.** A gain of Rs.3,400
- **B.** A loss of Rs.3,400
- **C.** A gain of Rs.1,400
- **D.** **A gain of Rs.2,000**

(20,000 – 17,200 = NBV 2,800) – (Sales Proceed 4,800) = Gain 2,000

5. **What is the annual depreciation for 20X7?**

$____________________16,000

Opening balance at cost 180,000 – cost of asset sold 20,000 = 160,000 x 10% = 16,000

CHAPTER – 11

CONTROL ACCOUNTS
Accounting for Receivables and Payables

Sr. No	Course Outline Topics	Lecture video
1	Why Control Account are Maintained	96
2	Formats of Debtors Control Accounts	97
3	formats of Creditors Control Accounts	98 and 99
4	Posting from Journal to individual accounts	100
5	Posting from Journal to control accounts	101
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7	Practice - Control Account Reconciliation	103 and 104
8	Practice - Control Account Reconciliation	105

Topic videos 96-105 are mandatory part of this module

Why Control Accounts are maintained

Control Account is a simple ledger account that represents numerous ledger accounts of similar nature. Entities, that grow in size, face difficulties in establishing control over multiple transactions under same head of account. This encounter is resolved through developing a system of maintaining control accounts.

For example, an entity deals with more than one hundred number of credit customers. The accountant of this entity would be required to report amount receivable from each individual customer as well as the recoverable amount from total receivables (debtors). In this case, for each individual customer, a debtor ledger account will be maintained as a memorandum or subsidiary record that will not be a part of the main/general ledger, whereas one controlling ledger account shall be prepared in the main/general ledger that will show total balance receivable from all the debtors. This single ledger account is known as *Control Account* because of its function to control all the individual debtor's ledger accounts.

Mostly, entities maintain control accounts for trade receivables, trade payables, payroll, and inventory. This chapter will discuss accounting system based on control accounts for trade receivables (debtors) and trade payables (creditors).

Formats of Debtors and Creditors Control Accounts

Following are the maximum possible items that may appear in *Debtors Control Account* and *Creditors Control Account*. While preparing Debtors Control Account, it must be noticed that its debit side should show the items that will cause increase in debtors' balance and items in credit side will cause a decrease in debtors' balance.

In the same way items that will cause increase in creditors balance are put in its credit side and items that will cause decrease in creditors balance are put in the debit side of Creditors Controls Account.

Let's go through the following formats of Debtors Control Account and Creditors Control Account:

Debtors' Control A/C
Trade Receivable Control A/C

Opening Dr. Balance b/f		*Opening Cr. Balance b/f*	
Credit sales (Invoice issued)		Cash received from debtors	
Refund to debtors		Cheques received from debtors	
Cheques dishonoured		Bills receivable accepted by debtors	
Bills receivable dishonoured		Discount allowed	
Interest charged to debtors		Bad debts	
		Sales return (Credit note issued)	
		Contra / set off / balance transferred	
Closing Cr. Balance c/f		*Closing Dr. balance c/f*	

Creditors Control A/C
Trade Payable Control A/C

Opening Dr. Balance b/f		*Opening Cr. Balance b/f*	
Cash paid to creditors		Credit purchases (Invoice received)	
Cheques paid to creditors		Bills payable dishonoured	
Bills payable given to creditors		Interest payable	
Discount received			
Purchases return (Credit note received)			
Contra / set off / balance transferred			
Closing Cr. Balance c/f		*Closing Dr. balance c/f*	

Practice 11.1 Posting from journals to individual accounts and control accounts

BOOKS OF ORIGINAL ENTRIES

Purchase Journal / Day book

DATE	PARTICULARS	Rs.
	A	2,000
	B	3,000
	C	1,000
	D	4,000
	A	2,500
	D	1,000
	B	3,000
		16,500

Purchases A/c. Dr
Creditors Control A/c. Cr

Sale Journal / Day book

DATE	PARTICULARS	Rs.
	O	5,000
	P	2,000
	Q	1,000
	O	2,000
	R	7,000
	Q	2,000
	P	3,000
	O	1,000
		23,000

Debtors Control A/c. Dr.
Sales A/c. Cr.

Purchase Return Journal / Day book

DATE	PARTICULARS	Rs.
	A	1,500
	C	1,000
	D	2,000
		4,500

Creditors Control a/c Dr
Purchases Return a/c Cr

Sale Return Journal / Day book

DATE	PARTICULARS	Rs.
	P	500
	O	1,500
	Q	1,000
		3,000

Sales Return a/c Dr
Debtor Control a/c Cr

General Journal / Transfer Journal

DATE	PARTICULARS	Dr.	Cr.
	Bad Debts A/c.	500	
	Debtor "O" A/c.		500

CASH BOOK

	DISC.	DEBTOR	TOTAL		DISC.	CREDITOR	Total
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
O		3,000		A	100	700	
P	100	150		B		2,000	
Q	50	700		D	200	1,500	
O		2,000		C		2,500	
R		5,000		B		1,000	
P		1,000		A		500	
	150	11,850			300	8,200	

SUBSIDARY / MEMORANDUM LEDGER

DEBTORS LEDGER / SALES LEDGER

O account	Rs.		Rs.
Sales Journal	5,000	Sales Return	1,500
Sales Journal	2,000	Cash Received	3,000
Sales Journal	1,000	Cash Received	2,000
		Bad Debts	500
		Balance c/f	1,000
	8,000		8,000

P account	Rs.		Rs.
Sales Journal	2,000	Sales Return	500
Sales Journal	3,000	Cash Received	150
		Cash Received	1,000
		Disc. Allowed	100
		Balance c/f	3,250
	5,000		5,000

Q account	Rs.		Rs.
Sales Journal	1,000	S.R.J.	1,000
Sales Journal	2,000	Cash Rec.	700
		Disc All.	50
		Balance c/f	1,250
			3,000

R account	Rs.		Rs.
Sales Journal	7,000	Cash Rec	5,000
		Balance c/f	2,000
	7,000		7,000

LIST	Rs.
O	1,000
P	3,250
Q	1,250
R	2,000
Total	**7,500**

CREDITORS LEDGER / PURCHASE LEDGER

A account	Rs.		Rs.
Purchase return	1,500	Purchase Journal	2,000
Cash Paid	700	Purchase Journal	2,500
Cash Paid	500		
Disc Received	100		
Bal. c/f	1,700		
	4,500		4,500

B account	Rs		Rs.
Cash Paid	2,000	Purchase Journal	3,000
Cash Paid	1,000	Purchase Journal	3,000
Balance c/f	3,000		
	6.000		6,000

C account	Rs.		Rs.
Purchase return	1,000	Purchase Journal	1,000
Cash Paid	2,500	Bal. c/f	2,500
	3,500		3,500

D account	Rs.		Rs.
Purchase return	2,000	Purchase Journal	4,000
Cash Paid	1,500	Purchase Journal	1,000
Disc Received	200		
Balance c/f	1,300		
	5,000		5,000

LIST	Rs.
A	1,700
B	3,000
C	-2,500
D	1,300
Total	**3,500**

MAIN LEDGER

Debtors Control A/c

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Opening balance b/f	0	Cash received	11,850
Sales	23,000	Sales return	3,000
		Bed debts	500
		Discount allowed	150
		Closing balance c/f	7,500
	23,000		**23,000**

Creditors Control A/c

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Cash paid	8,200	Opening balance b/f	0
Purchase return	4,500	Purchases	16,500
Discount received	300		
Closing Balance c/f	3,500		
	16,500		**16,500**

Sales Return A/c

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Sales Journal	3,000	Income statement	3,000
	3,000		**3,000**

Purchases Return A/c

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Income statement	4,500	Purchase Journal	4,500
	4,500		**4,500**

Sales A/c

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Income statement	23,000	Sales Journal	23,000
	23,000		**23,000**

Purchases A/c

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Purchases Journal	16,500	Income statement	16,500
	16,500		**16,500**

Discount Allowed A/c

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Debtors control A/c.	150	Income statement	150
	150		**150**

Discount Received A/c

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Income statement	300	Creditors control a/c	300
	300		**300**

Bad Debts A/c

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Debtors control A/c.	500	Income statement	500
	500		**500**

Important Tips to Remember (ITTRs)

1. A control account is a ledger account that appears in the main/general ledger, it summarises large volumes of transactions.

2. The debtors control account (sales ledger control account - total debtors account)

   - is used to record all transactions with credit customers
   - balance shows the total amount currently owed by all credit customers, this balance should agree with the list of individual balances extracted from the Sales Ledger (a memorandum ledger containing ledger accounts of individual debtors).

3. The creditors control account (purchase ledger control account - total creditors account).

   - is used to record all transactions with credit suppliers
   - balance shows the total amount currently owed to all credit suppliers, this balance should agree with list of individual balances extracted from the Purchase Ledger (a memorandum ledger containing ledger accounts of individual creditors)

4. Debtors Control a/c might produce two balances i.e. Dr. and Cr in this case the account will look like:

Debtors Control Account	
Opening Dr Balance	Opening Cr Balance (unusual)
Closing Cr Balance (unusual)	Closing Dr Balance

5. Creditors Control a/c might produce two balances i.e. Dr. and Cr in this case the account will look like

Creditors Control Account	
Opening Dr Balance (unusual)	Opening Cr Balance
Closing Cr Balance	Closing Dr Balance (unusual)

6. Regardless of the nature of ledger account, opening Dr balance would always appear in its debit side and opening Cr balance would always appear in its credit side.

7. Closing balances always appear in opposite side i.e. closing Dr balance will appear in credit side and closing Cr balance will appear in Dr side.

8. There might be a situation that a person who is Debtor (Customer) for the entity is also a Creditor (Supplier) of the same entity with different outstanding amounts.

   For example; Mohsin is Debtor with Rs.700 and Mohsin is also Creditor with Rs.500. In this case contra entry would be required to set-off these two balances. Contra entry is always recorded with lower balance of outstanding amount, in this case Rs. 500.

   The contra entry would be:

   Creditors Control A/c. (Mohsin) Dr. 500

   Debtors Control A/c. (Mohsin) Cr 500

9. In case Mohsin is Debtor with Rs.700 and Mohsin is also a creditor with Rs 1,000, the contra entry would remain the same as above but the amount would then be Rs. 700 the lower one:

   Creditors Control (Mohsin) Dr 700

   Debtors Control (Mohsin) Cr 700

10. Balance as per sales ledger means the balance as per list of debtors in sales ledger, whereas balance as per sales ledger control account means the total debtors balance in the main ledger / nominal ledger.

11. Cr balance in Debtors account might arise because of cash received in advance.

12. Dr balance in Creditors account might arise because of cash paid in advance.

13. Names of Accounting Records that are often confused by the students.

a.	Sales journal / day book	is a	Book of original entry (for credit sales)
b.	Sales ledger	is a	Subsidiary ledger (a book for debtors)
c.	Sales ledger control a/c	is a	Debtors control a/c in main/nominal ledger
d.	Sales account	is a	Sales income in main/nominal ledger

a.	Purchase journal / day book	is a	Book of original entry (for credit purchases)
b.	Purchase ledger	is a	Subsidiary ledger (a book for creditors)
c.	Purchase ledger control a/c	is a	Creditor control a/c in main/nominal ledger
d.	Purchase account	is a	Purchase expense in main/nominal ledger

14. Closing balance of control account may not agree with total of the list of individual balances extracted from the subsidiary ledger

a) Any difference must be investigated and corrections made

b) This may involve adjustments:
   - to the control account; and/or
   - to the list of balances as per subsidiary ledgers

	Reasons of difference	**Amendments**
I	Books of Original Entries a. Recording error b. Casting error	 Control a/c and List Control a/c only
II	Main Ledger - Control Accounts a. Posting error b. Casting error	 Control a/c only Control a/c only
III	Subsidiary Ledger – Individual Accounts a. Posting error b. Casting error	 List only List only
IV	List of Balances a. Listing error b. Casting error	 List only List only

Practice 11.2

Waheed & Sons have an accounting year ended 30 June 20X9. At that date the balance on the receivables ledger control account was Rs.130,000, but the total of the individual accounts in the receivables ledger came to Rs.127,240.

Upon investigation the following facts were discovered:

1. The sales day book total for week 22 had been overcast by Rs.600.
2. A credit balance of Rs.420 on Oreem's account had been incorrectly treated as a debit entry when listing the receivables ledger.
3. A contra of Rs.3,000 has been entered in Bungish's account in the receivables ledger but no other entry had been made.

The adjusted balance on the debtors control account is:

Particulars	Debit Rs.	Particulars	Credit Rs.
30 June 20X9		**30 June 20X9**	
Balance b/f (reopened)	130,000	Sales day book over cast by	600
		Contra entry in Bungish account	3,000
		Balance c/f	**126,400**
	130,000		130,000

The adjusted balance on the list of individual debtors is:

	Rs.
Balance as per list of individual balances 30 June 20X9 (Dr.)	127,240
Credit balance of Oreem account treated as debit balance (420 x 2) (Cr.)	- 840
Adjusted Balance as per list of individual debtors on 30 June 20X9 (Dr.)	**126,400**

Exercise Question 11.3

Babar Shafi prepared the following payables ledger reconciliation statement on 30th June 20X9:

		Rs.
Balance on purchase ledger control account	Cr.	46,865
Payment entered twice in purchase ledger control account	Cr.	573
	Cr.	47,438
Purchase daybook overcast	Dr.	900
Total of list of balances	Cr.	46,538

Which balance should be reported in the balance sheet as on 30th June 20X9?

Particulars	Debit Rs.	Particulars	Credit Rs.
30th June 20X9		**30th June 20X9**	
Purchase day book overcast	900	Balance b/f	46,865
		Payment posted twice in control account	573
Balance c/f (Liability)	**46,538**		
	47,438		47,438

Exercise Question 11.4

Jamil is preparing a reconciliation of the balance on the creditors ledger control account appearing in the general ledger to the total of the list of balances on the individual accounts in the purchase ledger. He has discovered the following:
(i) a debit balance on a supplier's individual account was listed as a credit balance;
(ii) an invoice for Rs.2,900 was entered in the purchase day book as Rs.9,200.

Which of the errors will require an adjustment to the creditors ledger control account?

A neither (i) nor (ii)
B (i) only
C **(ii) only**
D both (i) and (ii)

Exercise Question 11.5

At 28 February 20Y1 the balance on the trade receivables control account in Durdana Rizvi's general ledger was Rs.126,528, and the total of the list of balances from the sales ledger was Rs.125,092.

The following errors were identified:

i. a balance of Rs.79 due from a customer has been omitted from the list of balances;
ii. a debit balance of Rs.200 on a customer's account has been treated as a credit balance;
iii. a customer paid Rs.2,200 in full settlement of a balance of Rs.2,215. Only the cash received has been recorded;
iv. no entries have been made for a contra of Rs.780 with the purchases ledger;
v. the total of the sales day book was under-cast by Rs.99;
vi. the total of credit notes issued to customers in February, Rs.528, was posted to the general ledger as sales invoices; and
vii. a payment of Rs.145 from a customer was recorded in the cash received day book as Rs.154.

Prepare the reconciliation of the total of the list of balances to the corrected general ledger balance.

Trade Receivables Control Account (Adjusted)

Particulars	Debit Rs.	Particulars	Credit Rs.
28th February 20Y1		**28th February 20Y1**	
Balance b/f	126,528	Discount allowed not recorded (iii)	15
Sales day book undercast	99	Contra entries not recorded (iv)	780
Receipt overstated (vii)	9	Credit note issued recorded as sales (vi)	1,056
		Balance c/f	**124,785**
	126,636		126,636

		Rs.
Balance on sales ledger list	**Dr.**	**125,092**
i. Balance omitted from the list	Dr.	79
ii. Dr. balance of a customer treated as Cr. balance	Dr.	400
iii. Discount allowed not recorded in the books	Cr.	15
iv. Contra entry not recorded in the books	Cr.	780
vii. Receipt from customer overstated 154 – 145	Dr.	9
Adjusted balance of sales ledger list	**Dr.**	**124,785**

1. A payables ledger control account showed a credit balance of Rs.768,420. The payables ledger list totaled Rs.781,200.

Which one of the following possible errors could account in full for the difference?

- **A.** A contra against a receivables ledger debit balance of Rs.6,390 has been entered on the credit side of the payables ledger control account (by rectifying this error the control account balance will further reduce by Rs.12,780)
- **B.** **The total of discounts allowed Rs.28,400 was entered to the debit side of the payables ledger control account instead of the correct figure for discounts received of Rs.15,620**
- **C.** Rs.12,780 cash paid to a supplier was entered on the credit side of the supplier's account on the payables ledger(by rectifying this error the control account balance will further reduce by Rs.25,560)
- **D.** The total of discounts received Rs.6,390 has been entered on the credit side of the payables ledger control account (by rectifying this error the control account balance will further reduce by Rs.12,780)

Explanation: Payable Control account balance is showing Rs. 12,780 less balance comparing with the total of the payables' list; which means that excess amount has been debited in the control account.

2. The payables ledger control account below contains a number of errors:

Payables ledger control account

	Rs.		Rs.
Balance B/F	318,600		
Cash paid to suppliers	1,364,300	Purchases	1,268,600
Purchase returns	41,200	Contras against receivables	48,000
Refunds received from suppliers	2,700	Discounts received	8,200
		Balance C/F	402,000
	1,726,800		**1,726,800**

All items relate to credit purchases.

What should be the closing balance when all the errors are corrected?

- **A.** **$128,200**
- **B.** $509,000
- **C.** $224,200
- **D.** $144,600

Payables ledger control account

	Rs.		Rs.
		Balance B/F	318,600
Cash paid to suppliers	1,364,300	Purchases	1,268,600
Purchase returns	41,200	Refunds received	2,700
Contras against receivables	48,000		
Discounts received	8,200		
Balance C/F	**128,200**		
	1,589,900		**1,589,900**

3. The purchase day book of Humaira has been undercast by Rs.500, and the sales day book has been overcast by Rs.700. Humaira maintains payables and receivables ledger control accounts as part of the double entry bookkeeping system.

The effect of correcting these errors will be to:

- **A.** make adjustments to the ledger balances of the individual customers and suppliers, with no effect on profit
- **B.** make adjustments to the ledger balances of the individual customers and suppliers, with a decrease in profit of $1 ,200
- **C.** make adjustments to the control accounts, with no effect on profit
- **D.** **make adjustments to the control accounts, with a decrease in profit of Rs.1,200**

Explanation:

- (i) **By rectifying under-casting effect of purchase daybook, the cost of goods sold will increase by Rs.500 and by rectifying over-casting effect of sales daybook the sales will decrease. Both effects are decreasing profit with Rs. 1,200**
- (ii) **Adjustment in control is always required whenever there is a casting error occurring in books of original entries, because total sum of the books of original entries is posted to the control accounts.**

4. In reconciling the receivables ledger control account with the list of receivables ledger balances of SF Traders, the following errors were found:

1. The sales day book had been overcast by Rs.370.
2. A total of Rs.940 from the cash receipts book had been recorded in the receivables ledger control account as Rs.490.

What adjustments must be made to correct the errors?

- **A.** Credit debtors control account Rs.820. Decrease total of debtors list balances by Rs.820
- **B.** **Credit debtors control account Rs.820. No change in total of debtors ledger list balances.**
- **C.** Debit debtors control account Rs.80. No change in total of debtors' ledger list balances
- **D.** Debit debtors control account Rs.80. Increase total of debtors ledger list balances byRs.80

Explanation:

- (i) **By rectifying over-casting effect of sales daybook, the debtors control account will be credited with 370**
- (ii) **Cash receipt has been less recorded in the debtors control account with Rs. 450, now it shall be credited in debtors control account.**

5. **The debit side of a trial balance totals $50 more than the credit side. Which one of the following could this be due to?**

- **A.** A purchase of goods for $50 being omitted from the supplier's account
- **B.** A sale of goods for $50 being omitted from the customer's account
- **C.** An invoice of $25 for electricity being credited to the electricity account
- **D.** A receipt for $50 from a customer being omitted from the cash book (2 marks)

6. A receivables ledger control account had a closing balance of Rs.8,500. It contained a contra to the receivable ledger of Rs.400, but this had been entered on the wrong side of the control account.
What should be the correct balance on the control account?

- **A.** **Rs.7,700 debit**
- **B.** Rs.8,100 debit
- **C.** Rs.8,400 debit
- **D.** Rs.8,900 debit

Explanation: Rectification of double amount Rs.800 will be posted in the credit side of receivable ledger control account that will decrease the receivable control account balance to Rs. 7,700.

7. An inexperienced bookkeeper has drawn up the following receivables ledger control account:

Receivables Ledger Control Account

	Rs.		Rs.
Opening balance	180,000	Credit sales	190,000
Cash from credit customers	228,000	Irrecoverable debts written off	1,500
Sales returns	8,000	Contras against payables	2,400
Cash refunds to credit customers	3,300	Closing balance (balancing figure)	229,600
Discount allowed	4,200		
	423,500		**423,500**

What should the closing balance be after correcting the errors made in preparing the account?

A. $130,600

B. **$129,200**

C. $142,400

D. $214,600

	Rs.		Rs.
Opening balance	180,000	Cash from credit customers	228,000
Credit Sales	190,000	Irrecoverable debts written off	1,500
Cash refunds to credit customers	3,300	Contras against payables	2,400
		Sales return	8,000
		Discount allowed	4,200
		Closing balance (balancing figure)	129,200
	373,300		**373,300**

CHAPTER- 12

RECTIFICATION OF ERRORS

Sr. No	Course Outline Topics	Lecture video
1	Types of Errors	106
2	Errors that do not cause any difference in Trial Balance	107
3	Errors that do cause a difference in Trial Balance	108
4	Practice - Trial balance agreement	109
5	Practice - Suspense account	110 and 111
6	Practice - Calculation of Adjusted Profit	112
7	Practice - Calculation of Working Capital	113
8	Capital and Revenue	114

Topic videos 106-114 are mandatory part of this module

Types of errors

While performing functions of financial accounting i.e., classifying, recording, posting and reporting, there could be some instances of errors and omissions in the presence of which the financial statements do not present reliable and fair results of the economic phenomena of the entity. These errors and omissions need to be corrected according to the accounting rules so that the financial performance and position of the entity is reliable and fairly presented.

These errors and omissions are widely split into two categories:

1. Those errors that do not cause a difference in trial balance agreement
2. Those errors that do cause a difference in trial balance agreement.

1. **Errors that <u>do not</u> cause any difference in trial balance**

Sr. #	**<u>Reasons of Error</u>**	**<u>Rectifying Entry</u>**
a)	*Error of omission* When financial information is completely *omitted for recording in the books of original entry* e.g. sales invoice of Rs.1,000 issued before closing date but not recorded in the books of original entry.	Debtors a/c Dr. 1,000 Sales a/c Cr. 1,000
b)	*Error of commission* When correct accounting effect (Dr/Cr) is given in the wrong accounting head but the main head remains correct e.g. purchase of computer Rs.5,000 for office was wrongly debited to the furniture account. (both accounts belong to the same main head; Assets) This error will have no effect (positive or negative) on financial position as well as financial performance.	Computer a/c Dr 5,000 Furniture a/c Cr 5,000
c)	*Error of principle* When correct accounting effect (Dr/Cr) is given in the wrong accounting head as well as the wrong main head e.g. purchase of computer Rs.5,000 for office was wrongly debited to the stationery account. (both accounts belong to different main heads, like computer belongs to Asset and stationery belongs to Expense) This type of error will cause a difference in financial performance (net profit) and/or financial position (Asset = Owners' equity + Liability) Error of principle occurs because of wrong decision about capital and revenue nature at the time of recognizing accounting heads.	Computer a/c Dr 5,000 Stationary a/c Cr 5,000
d)	*Error of original entry* When correct accounting entry is recorded in the books of accounts but the amount in both accounting effect (Dr & Cr) is wrong although the amount is same e.g. debtors to be written off for Rs. 250 as bad debts were recorded in the correct accounts but the amount was posted in both accounts was Rs. 520, causing a difference of Rs. 270 in both sides. It is also known as transposition error.	Debtors a/c Dr 270 Bad debts a/c Cr 270
e)	*Compensating error* When the sum of more than one errors cancels the accounting effect of each other e.g. sales were less credited with Rs. 260 and at the same time opening balance of capital account was brought forward with an amount that is Rs. 200 more than the correct amount and Rent expense owing of Rs. 60 was although credited to rent payable account but was not debited to the rent expense.	Capital a/c Dr 200 Rent expense a/c Dr 60 Sales a/c Cr 260

2. **Errors that <u>do</u> cause a difference in trial balance**

Suspense account error

Whenever there is a difference in the trial balance, such amount of difference shall be named as suspense account. Suspense account is used to make both sides of trial balance equal.

Trial Balance

Particulars	Dr. (Rs)	Particulars	Cr. (Rs)
Assets	65,000	Capital	40,000
Expenses	13,000	Sales	100,000
Purchases	80,000	Liabilities	25,000
Drawings	2,500	Provisions	3,000
	160,500		**168,000**

In the above trial balance credit side is heavier than debit side by Rs. 7,500. In order to balance the trial balance, Rs.7,500 will be included in debit side as Suspense Account.

Trial Balance

Particulars	Dr. (Rs)	Particulars	Cr. (Rs)
Assets	65,000	Capital	40,000
Expenses	13,000	Sales	100,000
Purchases	80,000	Liabilities	25,000
Drawings	2,500	Provisions	3,000
Suspense a/c	7,500		
	168,000		**168,000**

Possible reasons for difference in the Trial Balance

Sr. #	Reasons of Error	<u>Rectifying Entries</u>	
a)	Under/over casting of a ledger account maintained in main ledger e.g. • sales income account was over-cast by Rs. 200	Sales a/c Dr Suspense a/c Cr	200 200
	• sales income account was under-cast by Rs. 500 ***(it will affect trial balance only)***	Suspense a/c Dr Sales a/c Cr	500 500
b)	Omission of a balance from trial balance e.g. balance of bad debts account Rs. 700 (already correctly accounted for) is not appearing in the trial balance. ***(it will affect trial balance only)***	Bad debts a/c Dr Suspense a/c Cr	700 700
c)	Balance representing an account appearing in trial balance with less or excess (wrong) amount e.g. Building a/c balance c/f Rs. 700,000 erroneously was appearing in the Trial Balance with Rs. 70,000 ***(it will affect trial balance only)***	Building a/c Dr Suspense a/c Cr	630,000 630,000
d)	An account was given debit effect instead of credit effect (causing difference with double amount) e.g. Sales of Rs. 800 on credit was correctly debited in Debtors a/c but was also debited to sales a/c mistakenly.	Suspense a/c Dr Sales a/c Cr	1,600 1,600
e)			

f)	A ledger account was given credit effect instead of debit effect (causing difference with double amount) e.g. Sales of Rs. 800 on credit was correctly credited in Sales a/c but was also credited in debtors' a/c mistakenly.	Debtors a/c Dr Suspense a/c Cr	1,600 1,600
	Single accounting effect, either Dr or Cr was recorded/posted in the books of account e.g. Sales of Rs. 800 on credit was posted in Sales a/c only	Debtors a/c Dr Suspense a/c Cr	800 800
g)	One of the accounting effects was recorded with wrong amount e.g. Sales of Rs. 800 on credit was correctly credited in Sales a/c but was wrongly debited to debtors' a/c with Rs. 80 only	Debtors a/c Dr Suspense a/c Cr	720 720

Practice 12.1

Anjum has extracted following balances from her books of accounts. She has forgotten to extract the balance from the discounts allowed account. What is the balance?

Accounting Heads	Rs.
Plant and machinery	95,000
Property	135,000
Inventory	6,400
Payables	3,600
Receivables	2,850
Bank overdraft	970
Loan	45,000
Capital	100,000
Drawings	32,000
Sales	362,000
Purchases	156,000
Purchase returns	2,200
Discounts allowed	?
Discounts received	3,500
Sundry expenses	82,500

Accounting Heads	Debit – Rs.	Credit – Rs.
Plant and machinery	95,000	
Property	135,000	
Inventory	6,400	
Payables		3,600
Receivables	2,850	
Bank overdraft		970
Loan		45,000
Capital		100,000
Drawings	32,000	
Sales		362,000
Purchases	156,000	
Purchase returns		2,200
Discounts allowed	?	
Discounts received		3,500
Sundry expenses	82,500	
Total	**509,750**	
Difference in Trial Balance (Discount allowed)	7,520	
Total	**517,270**	**517270**

Practice 12.2

A trial balance has been extracted and a suspense account opened. One error relates to the mis-posting of an amount of Rs.200, being discounts received from suppliers. This was recorded on the wrong side of the discounts account.

What will be the correcting journal entry?

Suspense account Dr.	**400**	
Discount allowed Cr.		**200**
Discount received Cr.		**200**

Practice 12.3

Layla has recorded a payment of Rs.880 for repairs of the company van from the bank. The correct entry was made to the bank account but no other entries were made.

What would be the journal entry to correct this error?

Van repair account Dr.	**880**	
Suspense account Cr.		**880**

Practice 12.4

Dazy recorded an amount of Rs.3,000 for rent. Both the rent account and the bank account were debited. What would be the journal to correct this error?

Suspense account Dr.	**6,000**	
Bank account Cr.		**6,000**

Practice 12.5

Tipu's trial balance at 31 October 20X9 is out of agreement, with the credit side totaling Rs.1,610 less than the debit side. Upon investigation, the following errors were discovered:

1. Debit side of the purchases account for October had been overcast by Rs.1,050.
2. Rent expense of Rs.240 had been debited to the rent income account.
3. The provision for doubtful debts, which was increased by Rs.280, had been recorded in the provision for doubtful debts account as a decrease.

Following the correction of these errors, the balance on the suspense account would be:

Suspense Account

Particulars	**Debit Rs.**	**Particulars**	**Credit Rs.**
20X9		**20X9**	
Purchase account over-cast	1,050	Difference b/f from TB	1,610
Provision for doubtful debts	560		
Balance	**NIL**		
	1,610		**1,610**

Practice 12.5

Rosy paid Rs. 500 for office cleaning in cash. She made the following accounting entry in her books:

Trade payables Dr.	500	
Cleaning expenses Cr.		500

What will be rectifying journal entry?

Cleaning expense Dr.	**1,000**	
Trade payable Cr.		**500**
Cash account Cr.		**500**

Important Tips to Remember (ITTR)

1. In certain circumstances, after rectifying all possible errors, there remains an unidentified balancing difference in the rectifying accounting entry; such effect (Dr./Cr.) shall be given to the suspense account.

2. In the questions of suspense account, sales book and purchases book are considered as Sales a/c and Purchases a/c respectively. Whereas, the correct concept is that sales book is a book of original entry and sales account is nominal ledger account representing revenue of the entity. Casting error in a book of original entry would have two-fold effects whereas, casting error in a nominal ledger account would have single effect accompanying with suspense account as balancing effect.

3. If, in a rectifying entry, any nominal accounting head, relating to Income Statement (Expense and Income) is given debit effect, it would cause a decrease in the net profit. And if credit effect is given, then there would be an increase in net profit figure that was previously calculated in presence of errors.

   Profit and Loss Adjustments

	Rs.
Profit before rectification of error	* *
+ Nominal a/c credited in rectifying entry	* *
- Nominal a/c debited in rectifying entry	(* *)
Adjusted Net Profit	***

4. If in a rectifying entry an account relating to current assets or current liabilities is given debit effect it would cause an increase in working capital. And if credit effect is given to any current asset or current liability, it would cause a decrease in working capital.
   Working Capital = Current Assets – Current Liabilities.

5. When Dr. side of Trial balance exceeds its Cr. Side the difference (named as suspense a/c) appearing in Cr. side is transferred to Cr. Side of Suspense A/c and vice versa.

6. Suspense a/c balance should be eliminated after rectification of all errors, but where some balance remains untraced in the Suspense A/c and it gives a closing balance, such balance whether Dr. or Cr. Should be closed in income statement and should never be carried forward in Statement of Financial Position (Balance Sheet) as asset or liability.

7. Concept of Capital and Revenue – Expenditure/Receipts should be taken care while recognizing accounting heads as Dr. or Cr.
   - Capital expenditure – Asset
   - Revenue expenditure – Expense
   - Capital receipt – Liability or Owners' Equity
   - Revenue receipt – Income

	Capital Expenditure	Revenue Expenditure	Capital Receipt	Revenue Receipt
1. Purchase of car	★			
2. Repair of car		★		
3. Purchase of computer	★			
4. Installation of software	★			
5. Purchase of USB for data transfer		★		
6. Receipt of Loan from bank			★	
7. Receipt of service fee				★
8. Construction of store room	★			
9. Rent of store room		★		
10. Wages for machine operator		★		

   Error that takes place because of wrong decision about the nature of accounting head; capital or revenue is known as error of principle.

MCQs

1. Which ONE of the following is an error of principle?

- **A.** A gas bill credited to the gas account and debited to the bank account
- **B.** The purchase of a non-current asset credited to the asset at cost account and debited to the supplier's account
- **C. The purchase of a non-current asset debited to the purchases account and credited to the supplier's account**
- **D.** The payment of wages debited and credited to the correct accounts, but using the wrong amount

2. Which one of the following journals is correct according to its narrative?

		Debit Rs.	Credit Rs.
A.	Sarfraz personal account	100,000	
	Directors' remuneration		100,000
	Bonus allocated to account of managing director (Mr Sarfraz)		
B.	Purchases	14,000	
	Wages	24,000	
	Repairs to buildings		38,000
	Transfer of costs of repairs to buildings carried out by company employees using materials from inventory		
C.	**Discounts allowed**	**2,800**	
	Discounts received		**2,800**
	Correction of error: discounts allowed total incorrectly debited to discounts received account.		
D.	Suspense account	20,000	
	Rent income		10,000
	Rent expense		10,000
	Correction of error: rent received credited in error to rent expense account.		

3. A trial balance extracted from a sole trader's records failed to agree, and a suspense account was opened for the difference. **Which of the following errors would require an entry in the suspense account in correcting them?**

1. Discount allowed was mistakenly debited to discount received account.
2. Cash received from the sale of a non-current asset was correctly entered in the cash book but was debited to the disposal account.
3. The balance on the rent account was omitted from the trial balance.
4. Goods taken from inventory by the proprietor had been recorded by crediting drawings account and debiting purchases account.

- **A.** All four items
- **B. 2 and 3 only**
- **C.** 2 and 4 only
- **D.** 1 and 3 only

4. A trial balance shows a total of debits of Rs.347,800 and a total of credits of Rs.362,350.

After adjusting for the following errors, what is the balance on the suspense account?

1. A credit sale of Rs.3,670 was incorrectly entered in the sales day book as Rs.3,760.
2. A non-current asset with a carrying value of Rs.7,890 was disposed of for Rs.9,000. The only accounting entry was to debit cash.
3. The provision for doubtful debts was increased from Rs.8,900 to Rs.10,200. The allowance account was debited in error.

A. Rs.26,150 debit

B. Rs.26,060 debit

C. Rs.26,240 debit

D. Rs.2,950 credit

Explanation:

1. **There will be no effect as the error is in the book of original entry that will require rectification of double entry with same amount**
2. **Debit suspense account with 9,000 and credit disposal account**
3. **Difference of 1,300 needs to be credited twice in the provision for doubtful debts account and debit 2,600 to suspense account.**

5. **The trial balance of Bab-al-Shams shows total debits of Rs.125,819 and total credits of Rs.118,251. Which of the following explains the difference in full?**

A. Discounts allowed of Rs.3,784 have been shown on the wrong side of the trial balance.

B. Discounts received of Rs.3,784 have been credited to the payables ledger control account.

C. The sales day book has been undercast by Rs.7,568.

D. An opening accrual of Rs.7,568 has been omitted from the rental expense account.

This information is relevant to the following TWO questions:
A company's draft financial statements for 20X5 showed a profit of Rs.630,000. However, the trial balance did not agree, and a suspense account appeared in the company's financial statements. Subsequent checking revealed the following errors:

1. The cost of an item of plant Rs.48,000 had been entered in the cash book and in the plant account as Rs.4,800. Depreciation at the rate of 10% per year (Rs.480) had been charged.
2. Bank charges of Rs.440 appeared in the bank statement in December 20X5 but had not been entered in the company's records.
3. One of the directors paid Rs.800 due to a supplier in the company's payables ledger by a personal cheque. The bookkeeper recorded a debit in the supplier's ledger account but did not complete the double entry for the transaction (The Company does not maintain a payables ledger control account).
4. The payments side of the cash book had been understated by Rs.10,000.

6. **Which of the above items would require an entry to the suspense account in correcting them?**

A. All four items

B. 3 and 4 only

C. 2 and 3 only

D. 1, 2 and 4 only

7. **What would the company's profit become after the correction of the above errors?**

A. Rs.634,760

B. Rs.624,760

C. Rs.624,440

D. Rs.625,240

(630,000 – 4,320 depreciation less charged – 440 bank charges not recorded)

CHAPTER – 13

FINAL ACCOUNTS WITH ADJUSTMENTS

Sr. No	Course Outline Topics
1	Preparation of Final Accounts
2	Practice - Adjustments for Fixed Assets – Rectification of Errors
3	How to Read Trial Balance Prior to Preparing Final Accounts
4	Adjusting Entries Prior to Preparing Final Accounts
5	Practice: BRS - Provision for Doubtful Debts - Claim against Loss
6	Important Tips to Remember

Topic115 – 120 are included in this chapter.

Preparation of Final Accounts

Preparation of final accounts means to prepare certain financial statements at the end of reporting period in order to achieve certain objective from the perspective of user group. Mostly the sole proprietors prepare following two financial statements as final accounts.

3. Income statement (Statement of profit or loss and other comprehensive income)
4. Balance sheet (Statement of financial position)

According to International Accounting Standard (IAS) 1, there are five components of financial statements; 1) Statement of Financial Position 2) Statement of Profit or Loss and Other Comprehensive Income 3) Statement of Cash Flows 4) Statement of Changes in equity and 5) Notes to the Financial Statements.

Income statement (Statement of Profit or Loss and Other Comprehensive Income) is prepared to know the financial performance of an entity. Financial performance refers to the profitability (profit or loss) of entity during an accounting period i.e., a year.

This is prepared with the help of all ledger account balances relating to incomes & expenses appearing in the trial balance. Income statement is prepared for a specific period for which starting and ending dates are defined, normally a year of 12 months, also known as ***reporting period***.

Remember this equation:	**Incomes – Expenses = Profit**

Balance sheet (Statement of Financial Position) is prepared to know the financial position of an entity. Financial position refers to the financial strength of entity on a specific date. Normally it is prepared at the end of reporting period, which is known as ***reporting date*** or balance sheet date.

Financial strength of an entity is ascertained through the sum of total assets (resources) and the sum of total financial sources required to finance these assets i.e. owners' equity and liabilities (sources).

Remember this equation:	**Assets = Owners equity + Liabilities**

Techniques to prepare final accounts / financial statements

It is important here to recall the accounting cycle i.e.;

Preparation of final accounts comes after extracting trial balance from ledgers. The technique to prepare final accounts is nothing but to read trial balance very carefully, identify the nature of accounting head correctly, and place its balance in the appropriate part of income statement and balance sheet.

Important tip to follow is to mark E/I/A/L/O while reading trial balance and then pass journal entries for adjustment. We shall practice these two techniques in the following section.

Practice 13.1

(Emphasizing on adjustment for fixed assets and rectification of errors)

Following is the Trial Balances as on **31.3.20X9** extracted from the books of Sheikh, who carries on business under the name and style of Al-Fanar Stores., at Lahore:

Particulars	**Dr. (Rs)**	**Cr. (Rs)**	**Particulars**	**Dr. (Rs)**	**Cr. (Rs)**
Cash in hand	1,400		Interest on loan from Bhutta	2,700	
Cash at bank	2,600		Rates & taxes	2,100	
Sundry debtors	86,000		Discount allowed to Debtors	2,400	
Stock on **1.4.20X8**	62,000		Discount received from creditors		1,600
Furniture & fixtures	25,000		Freight on purchases	400	
Depreciation (F&F)		3,600	Carriage inwards	800	
Equipment (Depreciation 4,000)	16,000		Carriage outwards	2,000	
Buildings (cost)	60,000		Drawings	12,000	
Motor car (Cost 30,000)	20,000		Printing and stationery	1,800	
Sundry creditors		43,000	Electricity charges	2,200	
12% Loan from Bhutta		30,000	Insurance premium	5,500	
Provision for bad debts		3,000	General office expenses	3,000	
Purchases	140,000		Bad debts	2,000	
Purchase returns		2,600	Bank charges	1,600	
Sales		230,000	Motor car expenses	3,600	
Sales returns	4,200		Capital A/c		162,000
Salaries	11,000				
Rent for godown	5,500		TOTAL	**475,800**	**475,800**

Prepare Income Statement for the year ended 31st March, 20X9 and the Statement of Financial Position (Balance Sheet) as at that date after making adjustments for the following information:

1. Depreciate: (a) Building by 5% on reducing balance method; (b) Furniture and fixtures by 10% on reducing balance method; One steel table purchased during the year for Rs 1,400 was sold for same price but the sale proceeds were wrongly credited to Sales Account; (c) Office equipment by 15% on straight line method; Purchase of a typewriter during the year for Rs 4,000 has been wrongly debited to purchase; and (d) Motor car by 20% on reducing balance method; A fully depreciated motor car, original cost Rs. 5,000 was sold during the year. The proceeds of Rs. 1,000 were credited to sales account, no other accounting entries for disposal were recorded. During the year a motor car was purchased for Rs. 10,000 on credit, this remained unrecorded.
2. Value of stock on reporting date was Rs 44,000.
3. One month's rent for godown is outstanding,
4. One month's salary is outstanding.
5. Interest on loan from Bhutta is payable at 12 percent per annum, this loan was taken on 1.5.20X8.
6. Provision for bad debts is to be increased by Rs. 1,500
7. Insurance premium includes Rs 4,000 paid towards proprietor's life insurance policy and the balance of the insurance charges cover the period from 1.4.20X8 to 30.6.20X9.
8. Building was bought during the reporting period, half of which is used for residential purpose by Sheikh.
9. Discount allowed to debtors Rs. 600 has been wrongly debited to discount allowed by the creditors.

Trial Balance

Mark – AEILO

Particulars	Dr. (Rs)	Cr. (Rs)	Particulars	Dr. (Rs)	Cr. (Rs)
Cash in hand A	1,400		Interest on loan from Bhutta E	2,700	
Cash at bank A	2,600		Rates & taxes E	2,100	
Sundry debtors A	86,000		Discount allowed to Debtors E	2,400	
Stock on **1.4.20X8** E	62,000		Discount received from creditors I		1,600
Furniture & fixtures A	25,000		Freight on purchases E	400	
Depreciation (F&F) – A		3,600	Carriage inwards E	800	
Equipment (Depreciation 4,000) A, – A	16,000		Carriage outwards E	2,000	
Buildings (cost) A	60,000		Drawings – O	12,000	
Motor car (Cost 30,000) A, – A	20,000		Printing and stationery E	1,800	
Sundry creditors. L		43,000	Electricity charges E	2,200	
12% Loan from Bhutta L		30,000	Insurance premium E	5,500	
Provision for bad debts – A		3,000	General office expenses E	3,000	
Purchases E	140,000		Bad debts E	2,000	
Purchase returns – E		2,600	Bank charges E	1,600	
Sales I		230,000	Motor car expenses E	3,600	
Sales returns – I	4,200		Capital account O		162,000
Salaries E	11,000				
Rent for godown E	5,500		TOTAL	**475,800**	**475,800**

Adjusting Entries

1. Depreciation expense for the year

Name of Assets	**Furniture & Fixture 10 % R B M**	**Equipment 15% Straight line**	**Building 5 % R B M**	**Motor car 20 % R B M**
Cost Opening	25,000	20,000	30,000	30,000
Addition	-	4,000	-	10,000
Deletion /Disposal	(1,400)	-	-	(5,000)
Closing Balance	23,600	24,000	30,000	35,000
Acc. Dep. Opening	3,600	4,000	-	10,000
Disposal	-	-	-	(5,000)
For the year	**2,000**	**3,600**	**1,500**	**6,000**
Closing balance	(5,600)	(7,600)	(1,500)	(11,000)
Net Book Value	18,000	16,400	28,500	24,000

Depreciation expense E		Dr.	13,100	
	Accumulated Depreciation – Furniture	Cr. – A		2,000
	Accumulated Depreciation – Equipment	Cr. – A		3,600
	Accumulated Depreciation – Building	Cr. – A		1,500
	Accumulated Depreciation – Motor Car	Cr. – A		6,000
Sales account – I		Dr.	1,400	
	Furniture & Fixture account	Cr. – A		1,400
Office equipment A		Dr.	4,000	
	Purchases account	Cr. – E		4,000
Motor car A		Dr.	10,000	
	Creditors for motor car	Cr. L		10,000
Accumulated depreciation motor car A		Dr.	5,000	
Sales – I		Dr.	1,000	
	Motor car	Cr. – A		5,000
	Profit on disposal of motor car	Cr. I		1,000

2. Closing Stock

Closing Stock	A	Dr.	44,000	
Cost of goods sold	– E	Cr.		44,000

3. Outstanding rent for godown – one month = 500 (5,500 = 11 months)

Rent for godown	E	Dr.	500	
Rent payable / owing	L	Cr.		500

4. Outstanding salaries – one month = 1,000 (11,000 = 11 month)

Salaries	E	Dr.	1,000	
Salaries payable / owing	L	Cr.		1,000

5. Interest on loan @ 12% (30,000) = 3,600 x 11/12 = 3,300 – 2,700 = 600

Interest on loan	E	Dr.	600	
Interest payable	L	Cr.		600

6. Increase in provision for doubtful debts

Bad debts	E	Dr.	1,500	
Provision for doubtful debts	– A	Cr.		1,500

7. Insurance premium includes insurance for proprietor

Drawings	– 0	Dr.	4,000	
Insurance premium	E	Cr.		4,000

Insurance prepaid for 3 months (1,500 x 3/15 = 300)

Prepaid Insurance	A	Dr.	300	
Insurance premium	E	Cr.		300

8. Half of the building purchased during the year is being used by owner for personal use

Drawings account	– 0	Dr.	30,000	
Building account	– A	Cr.		30,000

9. Discount allowed wrongly debited to discount received

Discount allowed	E	Dr.	600	
Discount received	I	Cr.		600

Al – Fanar Stores
Income Statement
For the Year Ended on 31 March 20X9

	Rs.	**Rs.**	**Rs.**
Sales (W-4)			223,400
Cost of Goods Sold			
Opening Stock		62,000	
Purchases (W-5)	133,400		
Freight	400		
Carriage inwards	800	134,600	
Closing Stock		(44,000)	(152,600)
Gross Profit			70,800
Operating Expenses			
Salaries	(11,000 + 1,000)	12,000	
Rent for Godown	(5,500 + 500)	6,000	
Interest on Loan	(2,700 + 600)	3,300	
Rates and Taxes		2,100	
Discount to Debtors	(2,400 + 600)	3,000	
Carriage outwards		2,000	
Printing & Stationery		1,800	
Electricity charges		2,200	
Insurance premium (W-6)		1,200	
General office Expenses		3,000	
Bad debts (W-2)		1,500	
Bank charges		1,600	
Motorcar Expenses		3,600	
Depreciation		13,100	56,400
Operating Profit			14,400
Other Income			
Discount Received	(1,600 + 600)	2,200	
Profit on Sale of Motor		1,000	3,200
Net Profit			17,600

Al – Fanar Stores

Statement of Financial Position

As At March 31, 20X9

		Rs.	Rs.
Assets			
Fixed Assets			
Furniture & Fixture	(W -1)	18,000	
Equipment	(W - 1)	16,400	
Building	(W - 1)	28,500	
Motor Car	(W - 1)	24,000	86,900
Current Assets			
Stock		44,000	
Trade Debtors	(W - 3)	83,500	
Prepaid Insurance	(W - 6)	300	
Cash in hand		1,400	
Cash at Bank		2,600	131,800
			218,700
Owners' Equity			
Capital		162,000	
Net profit		17,600	
Drawing	(W – 7)	(46,000)	133,600
Liabilities:			
Long Term			
Loan from Bhutta		30,000	
Current Liabilities			
Creditor for motor car		10,000	
Trade Creditors		43,000	
Outstanding Expense		1,500	
Interest on loan payable		600	85,100
			218,700

Working Notes:

W – 1

Fixed Asset and Depreciation

Name of Assets	Furniture & Fixture 10 % R B M	Equipment 15% Straight line	Building 5 % R B M	Motor car 20 % R B M
Cost Opening	25,000	20,000	30,000	30,000
Addition	-	4,000	-	10,000
Deletion /Disposal	(1,400)	-	-	(5,000)
Closing Balance	23,600	24,000	30,000	35,000
Acc. Dep. Opening	3,600	4,000	-	10,000
Disposal	-	-	-	(5,000)
For the year	2,000	3,600	1,500	6,000
Closing balance	(5,600)	(7,600)	(1,500)	(11,000)
Net Book Value	18,000	16,400	28,500	24,000

W – 2

Provision for Doubtful Debts

	Rs.		Rs.
Bad debts transferred	2,000	Balance b/f	3,000
		Bad debts	1,500
Balance c/f	2,500		
	4,500		4,500

Bad debts

	Rs.		Rs.
Debtors	2,000	Provision for D Debts	2,000
		Income Statement	1,500
Provision increased by	1,500		
	3,500		3,500

W – 3

	Rs.
Sundry Debtor	86,000
Provision for bad debts	(2,500)
	83,500

W – 4 Sales

Sale – Sale Return – Furniture – Profit & Loss A/c.

= 230,000 – 4,200 –1,400 –1,000

= 223,400

W – 5

Net Purchase

Purchase – Purchase return – office equipment

= 140,000 – 2,600 – 4,000

W – 6

Insurance prepaid

= 5,500 – 4,000

= 1,500 x 3/15 = 300

Insurance Premium

1,500 – 300 = 1,200

W – 7

Drawings 12,000 + 4,000 + 30,000 = 46,000

Practice 13.2

(Emphasizing on adjustment; bank reconciliation - provision for doubtful debts - claim against losses)

Following is the trial balance extracted from the books of Decent Traders as on December 31, 20X9.

	Dr. Rs	**Cr. Rs.**
Capital account		1,318,000
Drawing account	129,000	
Building	500,000	
Showroom racks	285,400	
Furniture & fixture	25,000	
Staff advance	17,400	
Provision for doubtful debts		39,400
Export sales		100,000
Local sales		2,189,400
Administrative expenses	659,600	
Bank overdraft (HBL)		2,400
Marketing expenses	20,000	
Cost of goods sold	1,027,400	
Sundry debtors	744,000	
Sundry creditors		243,400
Stock	200,000	
Cash at bank (MCB)	260,000	
Cash in hand	24,800	
TOTAL	**3,892,600**	**3, 892,600**

Following adjustments are to be incorporated in the books:

1. Charge depreciation at 10% on building, showroom racks and furniture & fixture
2. Sundry debtors include:
   a. A customer who is in default for Rs. 44,000 and expected recovery from him is not more than 75%;
   b. A customer owing Rs. 25,000 who is also a creditor for Rs. 30,000 (however setoff is not required)
   c. General provision for doubtful debts is to be calculated @ 5% of sundry debtors.
3. Provision for income tax is to be accounted for @ 40% of the net profit.
4. Balance as per bank statement received from MCB on 31 December 20X9 was different because of following reasons:

Un presented cheques	Rs. 8,000
Un collected cheques	Rs. 3,000
Un recorded standing orders (paid for trade subscription)	Rs. 2,000
Un recorded credit transfers (building rent realized)	Rs. 6,000

5. Goods valuing Rs. 10,000 were destroyed by fire and insurance company has admitted the claim for Rs. 7,500, no accounting entry has been passed for loss and claim.

You are required to prepare Income Statement for the year ended December 31, 20X9 and Statement of Financial Position (Balance Sheet) as at that date.

Decent Trader
Income Statement

For the Year Ended December 31, 20X9

	Rs.	Rs.	Rs.
Sales			
Local sales		2,189,400	
Export sales		100,000	2,289,400
Cost of Goods Sold – (W - 5)			(1,017,400)
Gross Profit			1,272,000
Administrative Expenses	659,600		
Marketing expense	20,000		
Operating Expenses		679,600	
Deprecation – (W - 1)		81,040	
Bad debts – (W- 2)		5,350	
Loss of goods – (W - 5)		2,500	
Trade subscription (Order)		2,000	(770,490)
Operating Profit			501,510
Other Incomes			
Rent realized (credit transfer)			6,000
Net Profit before Tax			507,510
Income Tax Provision (W - 4)			(203,004)
Net Profit after Tax			304,506

Decent Trader

Statement of Financial Position (Balance Sheet)
As at December 31, 20X9

		Rs.	Rs.
Assets			
Fixed Asset			
Building	(W - 1)	450,000	
Showroom Stock	(W - 1)	256,860	
Furniture & Fixture	(W - 1)	22,500	729,360
Current Assets			
Closing Stock		200,000	
Insurance Claim	(W - 5)	7,500	
Staff Advance		17,400	
Debtors	(W - 2)	699,250	
Cash at Bank	(W - 4)	264,000	
Cash in hand		24,800	1,212,950
			1,942,310
		Rs.	**Rs.**
Owners' Equity			
Capital		1,318,000	
Net profit		304,506	
Drawing		(129,000)	1,493,506
Liabilities:			
Provision for Income Tax		203,004	
Bank Overdraft		2,400	
Sundry Creditors		243,400	448,804
			1,942,310

Workings:

W – 1

Depreciation	Rate	Cost Rs.	Depreciation Rs.	N.B.V. Rs.
Building	@ 10 %	500,000	50,000	450,000
Show room Racks	@ 10 %	285,400	28,540	256,860
Furniture & Fixture	@ 10 %	25,000	2,500	22,500
		810,400	810,40	729,360

W – 2

		Rs.
Total Debtor		744,000
Provision for doubtful debts		
Goods debtors 25,000 x 0%	=	0
Specific debtors 44,000 x 25%	=	11,000
General debtors 675,000 x 5%	=	33,750
		44,750
Net Debtors = 744,000 – 44,750	=	699,250

Bad debts to be reported in Income Statement = 44750 - 39,400 = 5350

W – 3

Cash Book (MCB)

	Rs.		Rs.
B/f	260,000	Standing order	2,000
Direct credit	6,000	C /f	264,000
	266,000		266,000

W – 4

Income Tax 474,110 x 40 % = Rs. 189,644

W – 5

	Rs.	Rs.
Loss by fire	2,500	
Insurance Claim	7,500	
Purchases		10,000
Cost of Goods Sold		1,027,400
Less: Loss of Goods by fire		(10,000)
		1,017,000

Important Tips To Remember (ITTRs)

1. While reading the trial balance mark each accounting head as A-E-I-L-O for **A**ssets, **E**xpense, **I**ncomes, **L**iabilities and **O**wners equity items.

2. If both sides of a trial balance are equal then Expenses and Assets would always be appearing in the debit side whereas; Incomes, Liabilities and owners' equity would always be appearing in the credit side of trial balance. Each accounting head appears in the side of its own nature.

3. Take care of the contra items like purchase return, sales return, drawing, provision for doubtful debts, provision for depreciation. Balances of these accounting heads would always appear in the side opposite to the nature of their main head.

4. Items appearing in trial balance would have single effect in the Income Statement or Statement of Financial Position (balance sheet) because its second effect has already been recorded e.g.

   a. *prepaid salary account* appearing in debit side of trial balance is recognized in balance sheet as asset only because its second effect has already been credited to the salaries expense.

   b. *accrued rent account* appearing in credit side of trial balance is recognized in balance sheet as liability only because its second effect has already been debited to rent expense.

   c. *depreciation account* appearing in debit side of trial balance is recognized in the income statement as expense only because its credit effect has already been credited to the provision for depreciation account

5. Trial balance is prepared on end of the reporting period (closing date), therefore each accounting head in trial balance would be revealing its closing balance except;

   a. *capital accounts* that would always be giving opening balance because its closing balance would be ascertained after adjusting net profit or loss in it and subtracting drawings,

   b. *provision for depreciation account* would be opening balance if and only if depreciation expense for the year has not yet been accounted for and its adjustment is required outside the trial balance,

   c. *provision for doubtful debts account* would also be showing opening balance in the trial balance if and only if its adjustment is required outside the trial balance

6. Each adjustment appearing outside the trial balance would have two-fold effects debit and credit; in case of a difficult adjustment please be-careful that only two effects shall be recognized with equal amounts. For this purpose, always recall the rules of Dr & Cr.

7. If adjusted purchases or cost of goods sold is appearing in trial balance; it means that opening stock has already been added in it and closing stock has already been subtracted from it. In this case the stock appearing in trail balance shall be the closing stock and shall have single effect only i.e., it shall be shown as an item of current assets in the Statement of Financial Position (balance sheet).

8. Concept of direct and indirect expense does not exist in financial accounting language. Cost of goods sold expenses are wrongly termed as direct expenses whereas all operating expenses are wrongly termed as indirect expenses which is entirely baseless concept created and propagated by orthodox authors.

9. For classification purposes all expenses are categorized into five functions;

   i. Cost of goods sold expense,
   ii. Administrative expense,
   iii. Selling and distribution expense
   iv. Financial expense and
   v. Income tax expenses.

10. Cost of goods sold includes all those expenses which are incidental to the purchase of goods for reselling purpose and also for bringing those goods into saleable condition.

11. For trading entities, wages should not be classified as an item of COGS, rather it should be taken as administrative or selling expense. Wages expense shall be included in COGS of manufacturing entities only.

12. Wages & salaries account or salaries & wages account appearing in trial balance of a trading entity often cause a confusion among the students that which account should be included in COGS and which should be included in operating expense; remember, arrangement (transposition) of these words have no impact on functional classification of expense, these shall be recognized as operating expenses.

13. Administrative and selling expenses; together are known as operating expense. For the purpose of income statement of sole proprietorship and partnership; financial expense like bank charges and interest on loan may also be grouped in operating expense.

14. Accrued/Owing/Due/Outstanding/Payable Expenses: It means expenses incurred but not yet paid till the end of accounting period. If accrued expenses are found in adjustments then these should be added in particular expense given in trial balance to report expense in Income Statement. In balance sheet amount of accrued expenses also be shown as liability. Following adjusting entry is passed for accrued expense.

    Particular Expense A/C

        To Accrued Expense A/c

15. Accrued/Owing/Due/Outstanding/Receivable Income: It means income earned but not yet received till the end of accounting period. If accrued incomes are found in adjustments then these should be added in particular income given in trial balance to report income in Income Statement. In balance sheet amount of accrued incomes also be shown as asset. Following adjusting entry is passed for accrued income.

    Accrued Income A/C

        To Particular Income A/c

16. Prepaid/Advance/Unexpired/Paid in advance Expenses: If prepaid expenses are found in adjustments then these should be deducted from particular expense given in trial balance to report expense in Income Statement. In balance sheet amount of Prepaid expenses also be shown as asset. Following adjusting entry is passed for prepaid expense.

    Prepaid Expense A/C

        To Particular Expense A/c

17. Unearned/Prepaid/Advance Income: It means income received in advance but not yet earned till the end of accounting period. If unearned incomes are found in adjustments then these should be deducted from particular income given in trial balance to report income in Income Statement. In balance sheet amount of Unearned income also be shown as liability. Following adjusting entry is passed for unearned income.

    Particular Income A/C

        To Unearned Income A/c

MCQs

1. **The following is an extract from the trial balance of Gardeners:**

	Dr Rs.	Cr Rs.
Non-current assets	50,000	
Inventory	2,600	
Capital		28,000
Receivables	4,500	
Allowance for receivables		320
Cash	290	
Payables		5,000
Sales		120,000
Purchases	78,900	
Rental expense	3,400	
Sundry expenses	13,900	
Bank interest		270
	153,590	**153,590**

1. Rent of Rs.200 has been prepaid.
2. Inventory at the end of the year was Rs.1,900.
3. The allowance for receivables is to be Rs.200.

What is the profit for the year?

A. Rs.23,690
B. Rs.23,610
C. Rs.23,100
D. Rs.25,500

Draft Income Statement for the year	**Rs.**	**Rs.**
Sales		120,000
Cost of goods sold		
Opening inventory	2,600	
Purchases	78,900	
Closing inventory	-1,900	-79,600
Gross Profit		**40,400**
Bank interest income		270
Operating expenses		
Rent expense (3,400 – 200)	3,200	
Sundry expense	13,900	
Decrease in provision for doubtful debts	-120	-16,980
Net profit		**23,690**

2. The following year-end adjustments are required:

- Closing inventory of Rs.45,700 to be recorded.
- Depreciation at 20% straight line to be charged on assets with a cost of Rs.470,800.
- An Irrecoverable debt of Rs.230 to be written off.
- Unearned income of Rs.6,700 to be recorded.

What is the impact on net assets of these adjustments?

A. Rs.55,390 increase
B. Rs.55,390 decrease
C. Rs.41,990 decrease
D. Rs.41,990 increase

3. Following is an extract of trial balance prepared by inexperienced accountant of Akbary Traders. Prepare a Correct Trial Balance and trace the difference?

	Dr Rs.	Cr Rs.
Premises	500,000	
Provision for depreciation		120,000
Inventory		23,000
Capital	200,000	
Bank Loan		105,000
Receivables	43,500	
Carriage in		1,500
Allowance for receivables		3,400
Bank overdraft	1,010	
Payables		35,900
Sales		500,080
Cost of Sales	359,700	
Sales returns	10,300	
Sundry expenses	14,000	
Discounts allowed		1,340

A. RS.15,710 Dr

B. RS.14,730 Dr

C. **RS.12,050Dr**

D. RS.33,630 Dr

Corrected Trial Balance	Dr. Rs	Cr. Rs
Premises	500,000	
Provision for depreciation		120,000
Inventory	23,000	
Capital		200,000
Bank Loan		105,000
Receivables	43,500	
Carriage inwards	1,500	
Allowance for receivables		3,400
Bank Overdraft		1,010
Payables		35,900
Sales		500,080
Cost of Sales	359,700	
Sales returns	10,300	
Sundry Expenses	14,000	
Discount allowed	1,340	
Difference	**12,050**	
Total	**965,390**	**965,390**

CHAPTER - 14

MANUFACTURING ACCOUNT

Sr. No	Course Outline Topics
1	Reporting Requirements of Manufacturing Entities
2	Classification and Analysis of Cost of Production
3	Manufacturing Cycle
4	Types of Inventories
5	Format of Financial Statements of a Manufacturing Entity
6	Manufacturing Account Without Work in Process Inventory
7	Manufacturing Account with Work in Process Inventory

Topic 121 – 127 are included in this chapter.

Reporting requirements of Manufacturing Entities

Manufacturing entities are always concerned about reporting of cost incurred for production of goods. This cost in incurred during the process of converting raw material into finished goods. For better understanding of the procession of conversion from raw material into finished goods; we should first concentrate on the difference between trading entities and manufacturing entities.

Trading entities purchase goods in finished form, make those goods available in the showroom, do marketing to sell those goods to the customers. Examples include; importers, exporters, wholesalers and retailers. They do not enter into any process of reforming the finished goods. Showcasing, marketing and selling techniques may differ from trader to trader but these techniques do not include any process to modify or amend the product.

Manufacturing entities enter into a process through which raw-material is put into workshop where certain other costs are incurred to convert that raw-material into finished products. Examples include; furniture manufacturers, jewelry makers, bakery confectioners and construction contractors. Manufacturing entities also include the entities which do not convert raw-material into a finished product but they modify or improve the form of a product to be suitable for a potential customer. Examples include; rice mills, electrical fittings, canned food activities, and embroiders.

Accountants of trading entities split income statement into two main parts i.e., "*trading account"* and "*profit and loss account*". Whereas, accountants of manufacturing entities prepare *"manufacturing account"* in addition to trading and profit & loss account. Manufacturing account consolidates all the production costs that are incurred to bring a product into saleable condition. These costs are categorized as; "*direct cost"* and "*indirect cost"*. Direct cost includes; direct material, direct labour and other direct costs that can be independently traced as product cost. Indirect cost includes; factory overhead cost also known as product overhead cost. It is also a product cost but cannot be independently traced or identified in the cost of the product e.g., electricity bill of workshop, depreciation of production plant, rent of factory building.

Manufacturing account is prepared to produce "*cost of goods manufactured"* that is then transferred to the trading account as a substitute of purchases expense – in the case of trading entities. In the trading account of a manufacturing entity, cost of goods manufactured is adjusted with opening and closing balances of finished goods inventory, just like in case of a trading entity; purchases expense is adjusted with opening and closing inventories.

Manufacturing entities carry three types of inventories i.e., material inventory, work in process inventory, and finished goods inventory. Material and work in process inventories are treated in manufacturing account, whereas, finished goods inventories are treated in trading account.

Classification and Analysis of Cost of production

Material cost	=	Direct material cost	+	Indirect material cost
+		+		+
Labour cost	=	Direct labour cost	+	Indirect labour cost
+		+		+
<u>Other costs</u>	=	<u>other Direct costs</u>	+	<u>other Indirect cost</u>
<u>Total cost of production</u>	**=**	**<u>Prime cost</u>**	**+**	**<u>Factory overhead cost</u>**

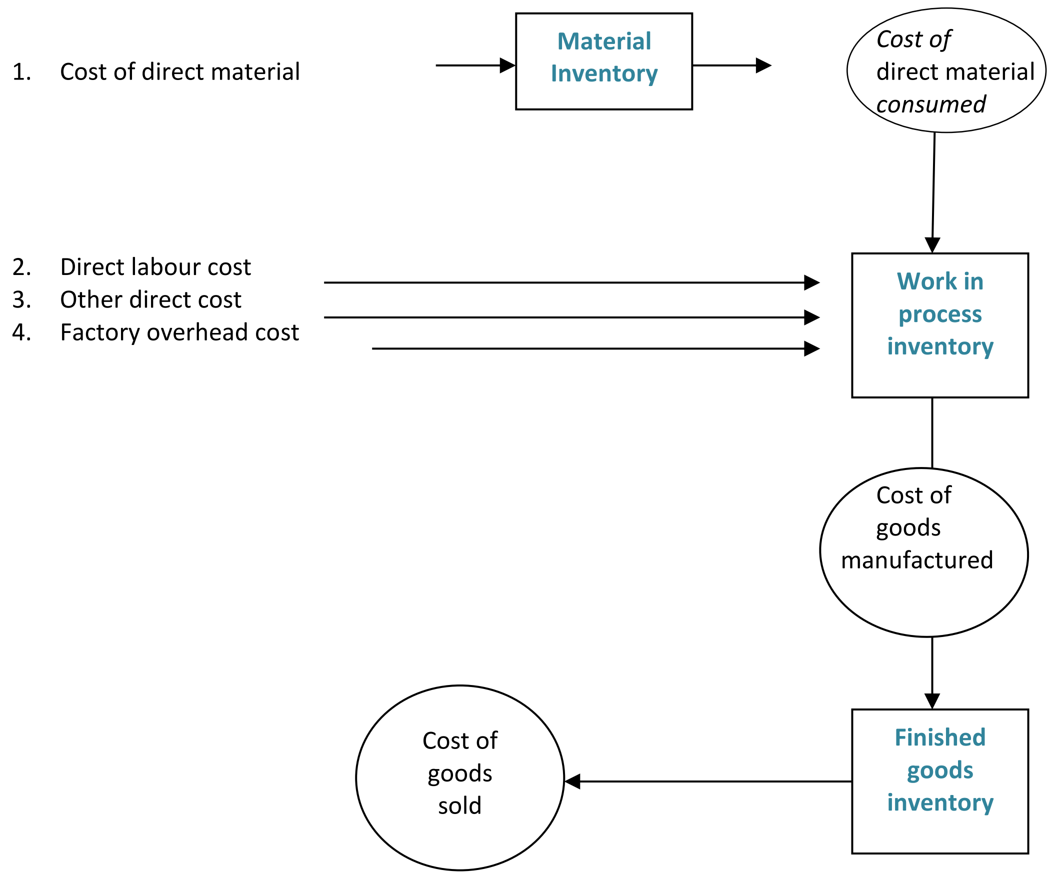
Other direct costs are those costs (other than direct material and direct labour) that have been incurred in full as a direct consequence of making a product or providing a service and can be identified independently in the cost of product. Examples include; the cost of specific tools, maintenance of specific jigs, and royalty at production level etc.

Difference between cost and expense Cost that expires is expense. Here question arises that why "direct material consumed" "direct labour" "factory overhead" "total Manufacturing" etc. are termed as "cost" whereas, these have already been incurred. Remember; these are incurred not expired. The cost that is incurred and also has expired during the accounting period is expense.

The cost of goods manufactured is transferred to finished goods inventory, unless it is sold it remains in the category of cost. The sooner these finished goods are sold, these become expense and the unsold finished goods are asset. This is because the entity obtains economic benefit upon expiry of the cost of produced goods by selling those to the customers.

That's why any component of the cost of production is not termed as expense. Whereas, "cost of goods sold" is expense (despite the fact that word "cost" is used in it)

MANUFACTURING CYCLE



Types of inventories

There are three types of inventories that can be identified in a manufacturing entity.

1. **Material and supplies inventory:** This is the inventory for raw materials, store items, spare parts and indirect materials that are used in production. It is the cost that represents un-consumed materials and supplies laying in the stores at the end of the reporting period.
2. **Work in process inventory:** This is the inventory of semi-finished goods. It is the cost that represents work in process, which remained semi-finished at the end of the reporting period; a further cost is still required to be incurred on this type of inventory in order to convert it into finished goods.
3. **Finished goods inventory:** This is the inventory of completed products, which are ready for sale. Finished goods inventory is the value of those fully manufactured products, which remained unsold at the end of the reporting period.

Format of financial statements of a manufacturing entity

Manufacturing Account:

Sample Company
Manufacturing Account
For the year ended 31st. December 20X9

	Rs.	Rs.	Rs.
Direct material consumed			
Opening inventory		***	
Purchases of raw material	***		
Returns outwards	(**)		
Carriage inwards	***		
Other receiving and handling cost of material	***		
Cost of material available for use		***	
Closing inventory		(**)	***
Direct labour			***
Other Direct cost			***
Prime cost			***
Factory overhead cost			
Indirect material		***	
Indirect labour		***	
Power & fuel		***	
Factory depreciation		***	
Other factory expenses		***	***
Total factory cost / manufacturing cost/production cost			***
Opening work in process inventory			***
Total cost put into process			***
Closing work in process inventory			(**)
Cost of goods manufactured			***

Trading Account:

Sample Company
Trading account
For the year ended 31st. December 20X9

	Rs.	*Rs.*
Sales	***	
Returns inwards	(**)	***
Cost of goods sold		
Opening finished goods inventory	***	
Cost of goods manufactured	***	
Cost of goods available for sale	***	
Closing finished goods inventory	(**)	(**)
Gross profit		***

<u>Conversion cost:</u>
Conversion cost is the cost incurred to convert raw material to finished goods.
Conversion cost = Direct labor cost + Factory overhead cost

Practice 14.1

Prepare cost of goods manufactured of Sandhu Sports for the year ended 31st. March 20X9:

	Rs.
Stock of raw material (opening)	1,500
Stock of raw material (closing)	2,100
Raw material purchases	24,000
Carriage inwards	1,000
Direct manufacturing wages	40,000
Royalty at production stage	5,000
Indirect manufacturing wages	12,000
Factory building rent	18,000
Depreciation plant & machinery	2,000
Other indirect factory cost	10,500

Opening and closing work in process inventories do not exist in this reporting period

Sandhu Sports
Manufacturing Account
For the year ended 31st. March 20X9

	Rs.	Rs.	Rs.
Direct material consumed cost			
Opening inventory		1,500	
Purchases of raw material	24,000		
Carriage inwards	1,000	25,000	
Closing inventory		(2,100)	24,400
Direct labour cost			40,000
Other direct cost (Royalty)			5,000
Prime cost			**69,400**
Factory overhead cost			
Indirect labour		12,000	
Factory building rent		18,000	
Depreciation plant & machinery		2,000	
Other indirect factory cost		10,500	42,500
Total factory cost			**111,900**
Opening work in process inventory			0
Closing work in process inventory			(0)
Cost of goods manufactured			111,900

Practice 14.2

Assuming the same data as given in Practice 14.1; prepare cost of goods manufactured, assuming the cost of opening work in process inventory is Rs.12,000 and the cost of closing work in process inventory is Rs.10,900.

Sandhu Sports
Manufacturing Account
For the year ended 31st. March 20X9

	Rs.	Rs.	Rs.
Direct material consumed cost			
Opening inventory		1,500	
Purchases of raw material	24,000		
Carriage inwards	1,000	25,000	
Closing inventory		(2,100)	24,400
Direct labour cost			40,000
Other direct cost (Royalty)			5,000
Prime cost			**69,400**
Factory overhead cost			
Indirect labour		12,000	
Factory building rent		18,000	
Depreciation plant & machinery		2,000	
Other indirect factory cost		10,500	42,500
Total factory cost			**111,900**
Opening work in process inventory			12,000
Closing work in process inventory			(10.900)
Cost of goods manufactured			**113,000**

Important Tips to Remember (ITTRs)

1. The “wages account” appearing in trial balance of a manufacturing entity shall be considered as a component of cost of production, direct labour cost, unlike for a trading entity where it was considered as an operating expense. Because without incurring direct labour cost raw material cannot be converted into finished product.

2. Direct cost means the cost that can be identified in a product (that is incurred in full as a direct consequence of producing the product). Whereas, the indirect costs are those production costs that are incurred in a reporting period for overall production process and cannot be identified in a product e.g. electricity bill that is not paid for a single product but for a period in which so many units of product are manufactured.

3. Cost of loose tools purchased, spare parts purchased, fuel purchased and indirect material purchased are adjusted with opening and closing inventory to calculate their consumption cost, which is then included in factory overhead cost. Their closing inventory, like other closing inventories, is shown in current assets.

MCQs

1. Nayyar Carpets manufactured 2,000 pieces of rugs during the year ending on 31st December 20X8. Following is the detail of manufacturing cost incurred during that year:

• Direct Material	Rs. 10,000 per piece
• Direct Labour	Rs. 6,000 per piece
• Manufacturing overhead (Variable)	Rs. 1,500 per piece
• Manufacturing overhead (Fixed)	Rs. 5,000,000

   What is the total cost of goods manufactured incurred during the year 20X8.

   A. Rs. 20 Million
   B. Rs. 30 Million
   C. Rs. 40 Million
   D. Rs. 50 Million

2. Identify, which of the following is a feature of variable manufacturing cost
   A. Cost per unit increases because of decrease in production
   B. Cost per unit decreases because of increase in production
   C. Cost per unit changes in proportion to the change in production
   D. Cost per unit remains constant because of change in production

3. Prime cost Rs. 30,000, Conversion Cost Rs. 50,000, Cost of Direct Material consumed is double of the Cost of Direct Labour. What is the amount of Cost of Goods Manufactured if opening Work in Process inventory is Rs. 5,000 lesser than the closing Work in Process inventory.
   A. 55,000
   B. 65,000
   C. 75,000
   D. 85,000

CHAPTER - 15

ACCOUNTING FOR INVENTORIES

Sr. No	Course Outline Topics - Chapter 15
1	Important Definitions as per IAS 2
2	Classification and Valuation of Inventories
3	Net Realizable Value - Finished Goods, WIP, Raw Material
4	Components of Cost of Inventory
5	Inventory Costing Methods
6	Accounting Systems to Record Inventories
7	Practice - Periodic and Perpetual System using FIFO and WAverage
8	Problem of Stock Taking under Periodic System
9	Practice - Physical Stock Count After the End of Reporting Period
10	Circumstances in which Inventory (Asset) is Recognized as Expense

Topic128 – 137 are included in this chapter.

Important Definitions as per IAS 2

Inventories are assets, held:

(a) for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make such sale.

Inventories

Material and Supplies

Work in Process

Finished Goods

Valuation Principles

Cost

Net Realisable Value

Lower of

For finished goods & work in process

Estimated Selling price
less Cost of Completion
less Cost to make such sales

For mutually Interchangeable Inventory

First In First Out
Weighted Average

For Specifically Identifiable Inventory

INDIVIDUAL COST METHOD

For Material and Supplies
Replacement Cost

Valuation of Inventories

Inventories shall be valued at lower of cost and net realizable value, on item-by-item basis or group basis.

Inventory is valued at the lower of:	
Cost	Net realizable value
That was paid to acquire the inventory	That can be realized by selling the inventory
Cost of Purchases + Conversion Cost	Selling Price – Further Costs to Sell

One of the important characteristics of financial information is that it should be '*reliable*'. For financial information to be reliable, a prudent view must be taken where there is certainty to ensure that assets and gains are not overstated and that liabilities and losses are not understated.

If net realizable value is lower than the cost of inventory, then it is anticipated that the entity is going to make a loss in future. To be prudent in valuing the inventory and to ensure reliability we should measure inventory at the lower figure, i.e. the net realizable value. Value of inventory is not overstated and the anticipated loss is recognized immediately in the Income Statement.

If cost of inventory is lower than the net realizable value, then it is anticipated that the entity is going to make a profit in future. In this case, inventory will be measured at its cost, which will ensure that the asset is not overstated and that the anticipated profit is not recognized.

Practice – 15.1

Bataka (Private) Ltd. has stock of finished shoes on December 31, 20X9 costing Rs15,000. The company also has a work in process inventory, the estimated cost to complete this work-in-process is Rs.5,000 on which cost of Rs.10,000 has already been spent till December 31, 20X9.

The company pays 2% commission on sales to its distributors. Estimated selling price of finished goods and work in process (when this will be converted to finished goods) is Rs. 35,000.

Its NRV shall be calculated as under:

		Rs.
Estimated Sales price		35,000
Less:	Estimated cost of completion	5,000
	Estimated cost necessary to make such sales (Rs. 35,000 x 2%)	700
		(5,700)
Net Realizable Value		29,300
Cost of inventory		
	Finished Goods	15,000
	Work in Process	10,000
Total cost of inventory		25,000

Cost of inventory is lesser than its net realizable value therefore the inventory will be recognized in the balance sheet at cost Rs. 25.000

Practice 15.2 - NRV of Raw Material

Cotton Expert Ltd. is engaged in manufacturing of cloth.

Price of cotton acquired by Cotton Expert Ltd. has fallen from Rs.200 per lb. to Rs.180 per lb.

At the end of the month company had 3,000 units which it had purchased @ Rs.200 per unit. The cloth made from this cotton is sold for Rs.500 per meter. The cost of producing one-meter cloth is Rs.400. One lb. of cotton is converted into one-meter cloth.

Calculate the value of inventory of Raw material.

Answer

As the finished goods are sold above their cost, so inventory of such raw material is not written down to NRV

Thus, the value of inventory

Rs.200 x 3,000 = Rs.600,000

Practice 15.3 - NRV of Raw Material

Prince Limited is engaged in a manufacturing business. One unit of raw material is converted into one unit of finished goods.

The cost of raw material acquired by the company is Rs.300 per unit. On January 31, due to excess supply price has fallen from Rs.300 to Rs.200.

The cost of producing one unit of finished goods is Rs.500 while NRV of the product is Rs.400 per unit.

Calculate the value of inventory of Raw Material. The company has 75 units of raw material at month end.

Answer

The value of inventory of Raw material will be written down to NRV/replacement cost, as the finished goods would not be sold at or above cost.

Thus, the value of inventory of raw material will be:

75 units @ Rs. 200 per unit = Rs. 15,000

Important Tips To Remember (ITTRs)

1. If NRV of finished goods is less than its cost then the inventory of Raw material (which is used in production of such finished goods) shall be valued at lower of its cost and NRV (Replacement cost).
2. Whereas, if NRV of finished goods is greater than its cost then the inventory of Raw material (which is used in production of such finished goods) shall be valued at its cost regardless of the fact that its NRV (replacement cost) is lower than its cost.
3. The amount of any reversal of any write-down of inventories, arising from an increase in net realizable value shall be recognized as a reduction in expenses in the period in which the reversal occurs.

Components of Cost of inventory

Cost of inventories comprises of:

i. costs of purchase,
ii. cost of conversion and
iii. other costs incurred in bringing the inventories to their present location and condition.

Cost of purchase

Cost of purchase comprise of

i. purchase price, less trade discount if any;
ii. import duties and other non-refundable taxes;
iii. transport and handling; and
iv. other cost directly attributable to acquisition of finished goods, materials and services.

Practice 15.4

Haroon Textile Ltd. imported raw material for use in production of goods with following details:

	Rs. (000)
Invoice value	1,000
Custom duty	150
Central Excise Duty (C.E.D)	50
Non-adjustable income tax	225
Refundable sales tax	180
Carriage	40
Commission paid to agent for clearance of raw materials	100

Calculate the cost of purchase of inventories

Cost of purchase Rs.

Invoice value	1,000
Custom duty	150
C.E.D.	50
Non-adjustable income tax	225
Carriage	40
Commission to agent	100
Cost of purchase	1,565

Costs that are not included in the cost of inventories and are straight away recognized as expenses.

Example of the costs that are excluded from the cost of inventories and straight away recognized as expenses in the period in which they are incurred are:

(a) abnormal amounts of wasted materials, labor or other production costs;

(b) storage costs, unless those costs are necessary in the production process before a further production stage;

(c) administrative overheads that do not contribute to bringing inventories to their present location and condition, and selling costs

Allocation of fixed and variable production overhead costs to the cost of inventory

(a) Allocation of fixed production overheads to the costs of inventories is based on normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average, over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance;

(b) The actual level of production may be used if it approximates normal capacity;

(c) The amount of fixed overhead allocated to each unit of inventory is not increased as a consequence of low production or idle plant;

(d) In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost; and

(e) Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

Practice 15.5

Jamil Bashir Limited is engaged in manufacturing of Surgical Instruments.

Following data relates to the reporting period ending on December 31, 20X9:

Fixed production overheads	=	Rs. 2,000,000
Variable production overheads	=	Rs. 200 per unit
Material cost per unit	=	Rs. 800 per unit
Labour cost per unit	=	Rs. 300 per unit

Normal production capacity of the company is 20,000 units per annum. During the year, company manufactured 5,000 units. There was nil balance of inventory on opening date and the company sold 4,000 units in the year.

Production Cost Per Unit	**Rs.**
Material	800
Labor	300
Variable overheads	200
Fixed production overheads [(on the basis of actual capacity) (2,000,000/5,000)]	400
Per unit cost	1,700

Inventory Cost Per Unit	
Material	800
Labor	300
Variable overheads	200
Fixed production overheads [(on the basis of normal capacity) (2,000,000/20,000)]	100
Per unit cost	1,400

Value of inventory	=	**1,000 units @ Rs. 1,400**
	=	**Rs. 1,400,000**

Inventory costing methods

If the entire inventory represents individually identifiable unit then the cost of inventory will be determined through the "*Specific Cost Method"*, i.e. Price per unit of individually identifiable inventory

However, if the inventory is mutually interchangeable and bought or produced at different prices then following methods are used to determine cost of inventory:

(i) *First in First out* (FIFO) an assumption is made for costing purposes that the first items of inventory received are the first items to be sold / issued. The closing inventory comprises the items purchased most recently.

(ii) *Weighted Average Cost* (W-AV-CO) under this system the inventory is valued at the weighted average price of the inventory on hand. This is achieved by dividing the total cost by the total units. The average cost will be computed every time additional inventory is purchased or produced.

Practice 15.6

Purchases	5 units at Rs.4/unit
	5 units at Rs.5/unit
	5 units at Rs.5.50/unit
Closing inventory	8 units

First In, First Out (FIFO)

	Rs.
5 units @ Rs.5.50	27.50
3 units @ Rs.5.00	15.00
Cost of closing inventory	**42.50**

Weighted average (Average cost – WAVCO)

Cost of closing inventory =

$$\frac{\text{Total cost of investory purchased}}{\text{No. of units purchased}} \text{ x no. of units in inventory}$$

$$\frac{(5\times Rs.4)+(5\times Rs.5)+(5\times Rs.5.50)}{15}\times 8 = Rs.38.67$$

Accounting systems to record inventories

There are two known methods that are used to account for inventories in the books of accounts;

1. Perpetual Inventory System:
2. Periodic Inventory System:

Perpetual Inventory System

Under this system, a complete and continuous record of movement in each inventory item is maintained. Perpetual records are useful in preparing monthly, quarterly or annual financial statements. Record used is normally a "store ledger card" specifying quantity wise receipt, issue and balance together with values in chronological sequence.

Accounting Entries:

On purchase of inventory (Purchase of goods is recognized as asset):

Inventory Purchase A/c.	Dr
Bank a/c or Creditors A/c.	Cr

On Issue/Use/Sale of inventory:

Cost of Consumption A/c.	Dr
Or	
Cost of Goods Sold A/c.	Dr
Inventory Purchases A/c.	Cr

Under this accounting system opening balance of inventory is brought forward in Inventory Purchase a/c and the same account leaves a balance at the end of the reporting period, which is reported as current asset in the statement of financial position.

Advantages:

1) It protects materials from theft or loss.
2) It helps in reducing wastage and spoilage.
3) Inventory levels can be determined and observed.
4) It serves as a moral check.
5) It helps in highlighting slow moving and obsolete inventory.
6) It helps in frequent physical counting.

Disadvantages:

1) It is very complex.
2) It is costly.
3) Complex calculations are required.
4) Sufficient technical knowledge is required.

Periodic inventory System or Physical system

Under this system, value of inventory is determined at the end of a reporting period through a physical count of inventory in store/warehouse. A continuous record is not maintained to account for day to day movement in inventory.

Accounting Entries:

On Purchase of Inventory (Purchase of goods is recognized as expense):

Purchases A/c.	Dr.	
Bank a/c or Creditors A/c.		Cr.

On Issue/Consumption/Sale of inventory

No accounting entry is passed to record such issue in the books of account.

On reporting date, the opening balance of inventory and total of purchases during the reporting period are closed into the cost of goods sold account:

Cost of Goods Sold A/c.	Dr.	
Opening Inventory A/c.		Cr.
Purchases A/c.		Cr.

On reporting date the closing balance is counted and measured according to the accounting principles and following accounting entry is recorded:

Closing Inventory A/c.	Dr.	
Cost of Goods Sold A/c.		Cr.

Advantages:

2) It is very simple.

3) It is very cheap.

4) No calculations required.

5) No technical knowledge required.

Disadvantages:

1) It does not protect materials from theft or loss.

2) No help in reducing wastage and spoilage.

3) Inventory levels cannot be fixed and observed.

4) It does not help in highlighting slow moving and obsolete inventory.

5) It does not help in frequent physical counting.

Accounting Entries for abnormal and normal loss of inventory*

Loss	**Perpetual System**	**Periodic System**
Abnormal Loss	Abnormal Loss Inventory A/c.	Abnormal Loss Purchase A/c.
Normal Loss	Cost of goods sold Inventory A/c.	No accounting entry is required

** Abnormal losses are covered by insurance, whereas normal losses are generally expected.*

Practice 15.7

Jan.

01. Opening balance 400 units @ Rs. 4 each
02. Purchase 1000 units @ Rs. 5 each
03. Sales 700 units @ Rs. 12 each
04. Purchases 1200 units @ Rs. 6 each
05. Sales 1000 units @ Rs. 12 each
06. Purchase 800 units @ Rs. 7 each
07. Sale 500 units @ Rs. 12 each

a). Enter the above transactions in the books of accounts under periodic and perpetual system of accounting.

b). Calculate the cost of inventory under periodic and perpetual systems using FIFO, and weighted average methods.

	Units		**Amount of Sales Rs.**
Opening inventory	400	700 x 12 =	8,400
Purchases (1,000+1,200+800)	3,000	1000 x 12 =	12,000
Unit available for sale	3,400	500 X 12 =	6,000
Units sold (700+1,000+500)	(2,200)		26,400
Closing inventory	1,200		

a) Accounting Entries (all figures are in Rs.)

Jan.	Periodic System			Jan.	Perpetual Systems		
05	Purchases	5,000		05	Inventory purchase	5,000	
	Cash		5,000		Cash		5,000
10	Cash	8,400		10	Cash	8,400	
	Sales		8,400		Sales		8,400
					Cost of goods sold	3,100	
					Inventory Purchases		3,100
					(FIFO method)		
15	Purchases	7,200		15	Inventory purchase	7,200	
	Cash		7,200		Cash		7,200
20	Cash	12,000		20	Cash	12,000	
	Sales				Sales		12,000
					Cost of goods sold	5,300	
					Inventory purchases		5,300
					(FIFO method)		
25	Purchases	5,600		25	Inventory purchase	5,600	
	Cash		5,600		Cash		5,600
30	Cash	6,000		30	Cash	6,000	
	Sale		6,000		Sales		6,000
					Cost of goods sold	3,000	
					Inventory Purchases		3,000
					(FIFO method)		
31	Cost of goods sold	1,600		31	Income Statement	11,400	
	Opening stock		1,600		Cost of goods sold		11,400
31	Cost of goods sold	17,800					
	Purchases		17,800				
31	Closing stock			31	Sales	26,400	
	Cost of goods sold		8,000		Income statement		26,400
31.	Income statement	11,400					
	Cost of goods sold		11,400				
31	Sales	26,400					
	Income statement		26,400				

Periodic System

Purchases (Exp)

Jan				
05	Cash	5,000		
15	Cash	7,200		
25	Cash	5,600	Cost of goods sold	17,800
		17,800		**17,800**

Sales

		10	Cash	8,400
		20	Cash	12,000
COGS	26,400	30	Cash	6,000
	26,400			**26,400**

Stock (Asset)

Bal b/f	1,600	Cost of goods sold	1,600
Cost of goods sold	8,000	Bal c/f	8,000
	9,600		**9,600**

Perpetual System

Inventory Purchases (Assets)

Jan			Jan		
01	Bal b/f	1,600	10	COGS	3,100
05	Cash	5,000	20	COGS	5,300
15	Cash	7,200	30	COGS	3,000
25	Cash	5,600	31	Bal c/f	8,000
		19,400			**19,400**

Cost of Goods Sold

10	Inventory purchase	3,100		
20	Inventory purchase	5,300		
30	Inventory purchase	3,000	Income Statement	11,400
		11,400		**11,400**

Sales

		10	Cash	8,400
		20	Cash	1,200
Inc. Statement	26,400	30	Cash	6,000
	26,400			**26,400**

Cost of Goods Sold

Opening stock	1,600	Closing stock	8,000
Purchases	17,800	Income Statement	11,400
	19,400		19,400

Opening Stock	1,600
Add: Purchases	17,800
Less: Closing stock	(8,000)
	11,400

b). Calculations of cost of inventory

Periodic System

FIFO method:

Closing inventory = 1200 units remained unsold		**Rs.**
800 x Rs.7	=	5,600
400 x Rs.6	=	2,400
Cost of Closing inventory		8,000

Weighted average cost method:

$$\frac{\text{Total cost (Opening Inventory + Purchases)}}{\text{Total unit (Opening Inventory + Purchases)}} = \text{cost per unit}$$

$$\frac{\text{Rs.}(1{,}600 + 17{,}800)}{(400 + 3{,}000)\text{ units}} = \text{Rs.}5.7058 \text{ per unit}$$

Cost of closing inventory = 1200 units x Rs. 5.7058 =Rs. 6,847

Perpetual System

FIFO Method

Date	Particulars	Received			Issues			Balance		
		Qty	Rate	Rs.	Qty	Rate	Rs.	Qty	Rate	Rs.
01	Op. Balance							400	4	1,600
05	Purchases	1000	5	5,000				400	4	1,600
10	Sales							1000	5	5,000
	(700 units)				400	4	1,600			
					300	5	1,500	700	5	3,500
15	Purchases	1200	6	7,200				700	5	3,500
								1200	6	7,200
20	Sales				700	5	3,500			
	(1000 units)				300	6	1,800	900	6	5,400
25	Purchases	800	7	5,600				900	6	5,400
								800	7	5,600
30	Sales				500	6	3,000	400	6	2,400
	(500 units)							800	7	5,600
								1200		8,000

Weighted Average Cost Method

Date	Particulars	Received			Issues			Balance		
		Qty	Rate	Rs.	Qty	Rate	Rs.	Qty	Rate	Rs.
01	Op. Balance							400	4	1,600
05	Purchases	1000	5	5,000				1400	(w-1) 4.7142	6,600
10	Sales				700	4.7142	3,300	700	4.7142	3,300
15	Purchases	1200	6	7,200				1900	(w-2) 5.526	10,500
20	Sales				1000	5.526	5,526	900	5.526	4,974
25	Purchases	800	7	5,600				1700	(w-3) 6.22	10,594
30	Sales				500	6.22	3,110	1200	6.22	7,464

Workings:

(W-1)

Rs.6,600 /1400 = 4.7142

(W-2)

(3,300+7,200)/(700+1,200) = 5.526

(W-3)

(4,974+5,600)/(900+800) = 6.22

Circumstances in which inventory (asset) is recognized as expense?

Following are the circumstances when inventory (asset) is recognized as expense:

(a) The inventories have been sold to customers, carrying amount of those inventories shall be recognized as cost of goods sold expense in the period in which the related revenue is recognized.

(b) The amount of any write-down of inventories to net realizable value and all losses of inventories due to theft or fire etc. shall be recognized as an expense in the period in which such write-down or loss occurs.

Practice 15.8 (Recognition of inventory as an expense)

Sumaiya Associates is engaged in production of surgical item. The following data is available for the month of March.

Opening stock	3,000 unit @ Rs. 100 per unit
Production	30,000 unit @ Rs. 100 per unit
Closing stock	2,000 unit @ Rs. 100 per unit

Expense charged to Income Statement.

	Rs.
Opening Stock	300,000
+ Production	3,000,000
	3,300,000
- Closing Stock	200,000
Cost of Goods Sold	3,100,000

OR

Unit sold	=	opening units + units produced - closing units		
	=	3,000 + 30,000 – 2,000		
	=	31,000 units		
Cost of goods sold	=	31,000 x 100	=	Rs. 3,100,000

Practice 15.9 (Recognition of inventory as an expense)

Hamza Traders has following data for the month of March:

Opening stock	300 units @ Rs. 100
Purchases	1,000 units @ Rs. 100
Closing stock	200 units

At 31 March, the NRV of the product comes down to Rs. 95.

Cost of inventory that should be recognized as expense.

	Closing Stock At NRV	**Closing Stock At Cost**
	Rs.	**Rs.**
Opening stock	30,000	30,000
Purchases	100,000	100,000
	130,000	130,000
Closing stock	(19,000)	(20,000)
Cost of goods sold	111,000	110,000

Thus, reducing the value of closing stock to NRV would cause increase in cost of goods sold.

In case the stock had valued at cost the cost of goods sold would have been Rs.110,000.

Problems of Stock taking under periodic system

Under periodic inventory system, closing stock is physically counted, verified and valued at the end of each reporting period. In case of big organizations, it may not be possible to verify entire closing stock exactly on the last date of accounting period. In such a case, stock-count takes place either few days earlier or later from the end of reporting period, as permitted by the circumstances.

If the stock count takes place on a later date, then following adjustments are required to ascertain the value of stock at the end of reporting period:

Start with the value of inventory on that later date (the stock count date is after the reporting date)

Add: Sales (at cost) between two dates, i.e. date of taking stock and reporting date.
Add: Purchases returns between the two dates.
Add: Any under-casting in stock sheet.
Add: Goods sent on consignment to the consignee, between the two dates.
Add: Goods lost because of any reason, between the two dates.
Add: Goods sold between these days are still in transit.
Less: Purchases between the two dates.
Less: Sales returns (at cost price) between the two dates.
Less: Any overcasting in stock sheet.
Less: Any goods held on consignment basis (received between the two dates).
Less: Any goods included in stock but title of such has been transferred to the buyer.

Do nothing:

Goods bought before closing date are still in transit (should be recognized as goods in transit)

If the stocks count takes place on an earlier date, then* following adjustments are *required* to *ascertain the value of stock at the end of reporting period:

Start with the value of inventory on that earlier date (the stock count date is before the reporting date)
Add: Purchases between the two dates.
Add: Sales returns (at cost price) between the two dates.
Less: Sales (at cost) between the two dates.
Less: Purchases returns between the two dates.
Add: Goods laying with consignee (at cost).
Add: Goods on approval with customers (at cost).

Practice 15.10 (Physical count after the end of reporting period)

Owing to some unavoidable circumstances the "Stock Taking Team" could not count the inventory on reporting date that was 31.12.20X9.
Cost of inventory as per the physical count on 05.01.20Y0 was Rs.150,000.

You, being the internal auditor, are required to calculate cost of inventory as on 31.12.20X9.
Following information was provided to you regarding the movement in inventory after the reporting date till the date of physical count:

(a) Sales totaled Rs. 120,000 of which 50% of the sales were made at a margin of 50%; 20% of sales were made at a mark-up of 25%; 10% of the sales were made at a loss of Rs.2,000 and 20% of the sales were made at cost.
(b) Sales returned were Rs.12,000 these goods were sold at 1/3rd profit of cost.
(c) Purchase of goods totaled Rs.50,000
(d) Purchases retuned were Rs.5,000.
(e) Goods costing Rs.12,000 were lost by theft.

Solution:

		Rs.
Cost of inventory as per physical count		150,000
(a)	Cost of sold goods during the period (W-1)	87,200
(b)	Cost of goods returned from customers during the period (W-2)	(9,000)
(c)	Cost of purchased goods during the period	(50,000)
(d)	Cost of goods returned to suppliers during the period	5,000
(e)	Cost of goods lost during the period	12,000
		195,200

Workings:

				Rs.
W-1	Sales 120,000	50% = 60,000 x $\frac{50}{100}$	=	30,000
		20% = 24,000 x $\frac{100}{125}$	=	19,200
		10% = 12,000 + 2,000	=	14,000
		20% = 24,000 + 0	=	24,000
		120,000		87,200

W-2 12,000 x $\frac{3}{4}$ = 9,000

Exercise Question 15.11 - (Specific Cost Method)

Delta Manufacturing Company is engaged in production of different items that are not ordinarily interchangeable.

During the month, the company produced following units:

Product A	2,000 units
Product B	3,000 units

Sales for the month are:

Product A	1,800 units
Product B	2,700 units

Cost of producing each unit of:

Product A	Rs. 500
Product B	Rs. 100

Value of Inventory using specific cost method	**Rs.**
Product A (200 x 500)	100,000
Product B (300 x 100)	30,000
Value of Inventory	130,000

Exercise Question 15.12 (Mutually Interchangeable Inventory - FIFO method (Periodic System of Accounting)

Mobile Filling Station carries valuation of supplies at the end of each month. For the month of February following information is available from the records of the company.

Stock on February 28, 2009	130,000 litres
Purchase – 10 February, 2009	150,000 litres @ Rs. 10.65
Purchase – 17 February, 2009	100,000 litres @ Rs. 10.50
Purchase – 28 February, 2009	100,000 litres @ Rs. 10.60
Sales during the month	345,000 litres
Stock on January 31, 2009	125,000 litres @ Rs. 9.75

Cost of Inventory using FIFO method	**Rs.**
100,000 litres @ Rs. 10.60	1,060,000
30,000 litres @ Rs. 10.50	315,000
Value of inventory	1,375,000

Exercise Question 15.13 (Mutually Interchangeable Inventory-W. Avg. cost method (Periodic System of Accounting).

Shah Petroleum Services engaged in supply of petroleum products.

For the month of September following information available:

Stock on 31 August, 20X9	25,000	litres @ Rs. 37.01
Purchase –05 September, 20X9	100,000	litres @ Rs. 37.35
Purchase –15 September, 20X9	100,000	litres @ Rs. 37.15
Purchase –25 September, 20X9	100,000	litres @ Rs. 37.05
Stock on 30 September	30,000	litres

Value of inventory using monthly weighted average method

Date 20X9	Units (litres)	Rate (Rs.)	Price (Rs.)
Sep 01	25,000	37.01	925,250
Sep 05	100,000	37.35	3,735,000
Sep 15	100,000	37.15	3,715,000
Sep 25	100,000	37.05	3,705,000
	325,000		12,080,250

Weighted average rate = $\frac{12,080,250}{325,000}$ = Rs. 37.17

Cost of inventory = 30,000 x 37.17 = Rs. 1,115,100

Exercise Question 15.14 (Net Realizable Value)

Steady Limited owns following products in its inventory on December 31, 20X9 with details given below:

Items	Units	Cost per unit (Rs.)	NRV per unit (Rs.)
Josh	400	5,000	6,000
Jazba	400	4,500	4,000
Junoon	200	400	410
Janem	300	600	500

Value of inventory on items by item basis:

Items	Units	Cost per unit (Rs.)	NRV per unit (Rs.)	Valuation	Lower of Cost & NRV Rs. (Total)
Josh	400	5,000	6,000	(400x5,000)	2,000,000
Jazba	400	4,500	4,000	(400x4,000)	1,600,000
Junoon	200	400	410	(200x400)	80,000
Janem	300	600	500	(300x500)	150,000
Value of Inventory					3,830,000

Exercise Question 15.15 (Net Realizable Value)

Bataka Pakistan Limited is engaged in manufacturing of shoes and bags. Following is the detail of bags held by one of its retail outlets.

Items	Units	Cost per unit (Rs.)	NRV per unit (Rs.)
P450	900	100	80
F 160	200	400	410
L120	300	600	500
Q200	100	300	400

Calculate value of inventory to be recognized in the books on aggregate (group) basis.

Items	Units (Bags)	Cost per unit Rs.	Total Cost Rs.	NRV per unit (Rs.)	Total NRV Rs.
P450	900	100	90,000	80	72,000
F160	200	400	80,000	410	82,000
L120	300	600	180,000	500	150,000
Q200	100	300	30,000	400	40,000
			380,000		344,000

NRV of the entire inventory is lower than the cost, therefore value of inventory should be measured at NRV which is Rs. 344,000

Exercise Question 15.16 (Net Realizable Value)

Stream Limited is engaged in production of fountain pens.

At the year end, the company owns following inventory.

Items	Units	Cost per unit	NRV per unit
		Rs.	Rs.
K 300i	300	100	80
K 500i	200	5,000	6,000
K 700i	100	4,500	4,000
J 200i	400	300	400
C 100	400	400	410
C 110	900	600	500
C 200	1,000	50	55
N 500	50	100	95
N 600	200	50	40

Calculate the amount of inventory by aggregate (group) and by category (item-wise) basis.

Aggregate (group) basis:

Items	Units	Cost	NRV	Total	Total	Lower of	
			per unit	per unit	Cost	NRV	Cost & NRV
			Rs.	Rs.	Rs	Rs.	Rs.
K 300i	300		100	80	30,000	24,000	
K500i	200		5,000	6,000	1,000,000	1,200,000	
K700i	100		4,500	4,000	450,000	400,000	
					1,480,000	1,624,000	1,480,000
J 200i	400		300	400	120,000	160,000	120,000
C100	400		400	410	160,000	164,000	
C110	900		600	500	540,000	450,000	
C200	1,000		50	55	50,000	55,000	
					750,000	669,000	669,000
N500	50		100	95	5,000	4,750	
N600	200		50	40	10,000	8,000	
					15,000	12,750	12,750
Value of Inventory						**2,281,750**	

Category (item-wise) basis

Items	Cost	NRV	Lower	Units	Value
	Rs.	Rs.	Rs.		Rs.
K 300i	100	80	80	300	24,000
K 500i	5,000	6,000	5,000	200	1,000,000
K 700i	4,500	4,000	4,000	100	400,000
J 200i	300	400	300	400	120,000
C 100	400	410	400	400	160,000
C 110	600	500	500	900	450,000
C 200	50	55	50	1,000	50,000
N 500	100	95	95	50	4,750
N 600	50	40	40	200	8,000
Value of inventory					**2,216,750**

Practice 15.17 - Disclosures

(a) Inventories are measured at lower of cost and NRV. Cost is measured by using FIFO, formula.

(b) Inventories comprise the following:

	Rs.'000'
Raw Material	5,400
Work in Process	6,200
Finished Goods	7,600
	19,200

(c) Carrying amount of finished goods at NRV is Rs.200,000.

(d) Inventories recognized as expense during the period are Rs.96,000,000.

(e) The amount of write-down of inventory (Finished goods) recognized as expense during the period is Rs.500,000.

(f) There is a reversal of write-down of Rs.100,000.

(g) Due to market fluctuations, finished goods are reversed from NRV to cost.

(h) Stock is pledged as security against short term loan.

1. **Which of the following statements about the treatment of inventory and work in progress in financial statements are correct?**
   1. Inventory should be valued at the lower of cost, and replacement value.
   2. In valuing work in progress, materials costs, labor costs and variable and fixed production overheads must be included.
   3. Inventory items can be valued using either first in, first out (FIFO) or weighted average cost.
   4. A company's financial statements must disclose the accounting policies used in measuring inventories.

   A. All four statements are correct
   B. 1, 2 and 3 only
   C. 2, 3 and 4 only
   D. 1 and 4 only

2. Pash Jee is publisher of books. On each sale, commission of 4% is payable to the selling agent. Following information is available in respect of total inventories of three of his most popular titles at his financial year-end:

	Cost Rs.	**Selling price Rs.**
History is Future	2,280	2,900
Down to Sky	4,080	4,000
Dancing Dove	1,280	1,300

What is the total value of these inventories in Pasha Jee's Balance Sheet

A. Rs.7,368
B. Rs.7,400
C. Rs.7,560
D. Rs.7,640

3. What would be the effect on a company's profit of discovering inventory with cost of Rs.1,250 and a net realisable value of Rs.1,000, assuming that the same inventory had not been included in the original inventory count?

   A. An increase of Rs.1 ,250
   B. An increase of Rs.1,000
   C. A decrease of Rs.250
   D. No effect at all

4. Shazi & Co sells three products - Basic, Super and Luxury. The following information was available at the year-end:

	Basic	**Super**	**Luxury**
	Rs. per unit	**Rs. per unit**	**Rs. per unit**
Original cost	6	9	18
Estimated selling price	9	12	15
Selling and distribution costs	1	4	5
Inventory	200 units	250 units	150 units

The value of inventory at the year-end should be:

A. Rs.4,200
B. Rs.4,700
C. Rs.5,700
D. Rs.6,150

5. The closing inventory of a company at cost on 31 January 20X8 amounted to Rs.284,700. The following items were included at cost in the total:

1,400 coats, which had cost Rs.80 each and normally sold for Rs.150 each. Owing to a defect in manufacture, they were all sold after the reporting date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds. 2,800 skirts, which had cost Rs.20 each. These too were found to be defective. Remedial work in February 20X8 cost Rs.5 per skirt and selling expenses for the batch totaled Rs.800. They were sold for Rs.28 each.

What should the inventory value be according to IAS 2 Inventories after considering the above items?

- **A.** Rs.280,050
- **B.** Rs.280,850
- **C.** Rs.294,850
- **D.** **Rs.272,450**

CHAPTER - 16

ACCOUNTING FOR PARTNERSHIP FIRMS

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Topic videos 138-157 are mandatory part of this module

Reporting difference between sole proprietorship and partnership entities

Sole proprietorship and partnership both entities prepare Income Statement (Profit and loss account) and Statement of Financial Position (Balance Sheet) in a same manner. The only difference that is identified while preparing reports of both types of entities is distribution of profits among the owners.

Profit distribution statement

For sole-proprietorship; the net profit/loss amount is directly transferred to the owner's capital account. For partnership firms; a statement is prepared in addition to the income statement and Statement of Financial Position (balance sheet). It shows how profit is distributed among the partners, the outcome of which is the distributed profit that is then posted to the partners' current accounts.
Profit as per Income Statement for the period is transferred to profit and loss appropriation account also named as profit distribution statement. In this statement the profit is distributed among the partners (owners) in accordance to their agreed profit sharing arrangements.

Profit is distributed among the partners based on three facts:

Basis for distribution	Facts and Reasons
Interest on Capital	Difference in amount of contributed capital
Partner's Salary	Difference in services performed
Profit sharing ratio	Difference in experience and personal contacts

Interest on drawings

Before distributing profits among the partners, adjustment for interest on drawings is made on the grounds that; had the drawings not been made by the partners the firm would have earned more profits. Therefore, the amount of interest on drawings is subtracted from each partners' profit share and is added in the total profits before applying profit sharing ratio.

Profit distribution statement

For partnership firms; a statement is prepared in addition to the income statement and Statement of Financial Position (balance sheet). It shows how profit is distributed among the partners, the outcome of which is the distributed profit that is then posted to the partners' current accounts.

Change in profit sharing ratio during the reporting period

Partners may decide to change profit sharing arrangements during the reporting period. In this case firstly; Income Statement is prepared for the reporting period, then its outcome (Net Profit) is split into two i.e.;

(i) Profit belonging to the period with old profit sharing arrangements.

(ii) Profit belonging to the period with new profit sharing arrangements.

In normal circumstances the profit is split on time proportionate (number of months) basis.

Two profit distribution statements are prepared for one reporting period and then their results are consolidated in partner's current account.

Practice 16.1

X, Y and Z set up a partnership firm on 1-1-20X9. They contributed Rs.150,000, Rs.120,000 and Rs.90,000 respectively as their Capitals and decided to share Profit & Loss in the ratio of 3: 2: 1.

The partnership deed provides that X is to be paid a salary of Rs.3,000 per month and Y Rs.15,000 per annum. It also provides that interest on Capital be allowed at 6% per annum. The drawings and Interest on drawings for the year were as follows:

Partners	Drawings Rs.	Interest on drawings Rs.
X	40,000	810
Y	20,000	540
Z	10,000	270

The Net amount of profit as per Income Statement for the year 20X9 was Rs.106,980.

Prepare a Profit & Loss Distribution Statement, Partners' Current Accounts and Partners' Capital Account.

Answer

Profit & Loss Distribution Statement
OR
(Profit and loss appropriation account)

	X Rs.	Y Rs.	Z Rs.	Total Rs.
Net profit				106,980
Interest on drawings	(810)	(540)	(270)	1,620
Partners salaries	36,000	15,000	-	(51,000)
Interest on Capital				
X 150,000 x 6%	9,000			
Y 120,000 x 6%		7,200		
X 90,000 x 6%			5,400	(21,600)
				36,000
Profit ratio				
X 36,000 x 3/6	18,000			
Y 36,000 x 2/6		12,000		
Z 36,000 x 1/6			6,000	(36,000)
	62,190	33,660	11,130	Nil

Partners' Capital Accounts

	X Rs.	Y Rs.	Z Rs.		X Rs.	Y Rs.	Z Rs.
				Balance b/f	150,000	120,000	90,000
Balance c/f	150,000	120,000	90,000				
	150,000	120,000	90,000		150,000	120,000	90,000

Partners Current Account (Abridged)

	X Rs.	Y Rs.	Z Rs.		X Rs.	Y Rs.	Z Rs.
Drawings	40,000	20,000	10,000	Balance b/f	0	0	0
				Profit share	62,190	33,660	11,130
Balance c/f	22,190	13,660	1,130				
	62,190	33,660	11,130		62,190	33,660	11,130

Partners Current Account (Detailed)

	X Rs.	Y Rs.	Z Rs.		X Rs.	Y Rs.	Z Rs.
Interest on drawing	810	540	270	Balance b/f	0	0	0
				Partner Salary	36,000	15,000	
Drawings	40,000	20,000	10,000	Int. on Capital	9,000	7,200	5,400
Balance c/f	22,190	13,660	1,130	Profit ratio	18,000	12,000	6,000
	63,000	34,200	11,400		63,000	34,200	11,400

Calculation of interest on Capital

Interest on capital is calculated on the effective capital balances at an agreed rate of interest.

Practice 16.2

January 1, 20X8	Capital Balances	Rs.
	A	50,000
	B	75,000
June 30, 20X8	Capital introduced by A	20,000
August 31, 20X8	Capital introduced by B	45,000

Calculate Interest on Capital at 10%, accounting year ends on December 31, 20X8.

Effective Capital Balances		Rs.	Rs.
A	Opening	50,000	
	Fresh 20,000 x 6/12	10,000	60,000
B	Opening	75,000	
	Fresh 45,000 x 4/12	15,000	90,000

Interest on Capital

A	60,000 x 10%	6,000
B	90,000 x 10%	9,000

Calculation of interest on Drawings

Interest on drawings is calculated on the effective drawings balances at an agreed rate of interest.

Practice 16.3

Drawings made by partners during the year ending on December 31 were as under:

Dates of drawings	Partner A Rs.	Partner B Rs.
March 31, 2008	4,000	6,000
June 30, 2008	3,000	2,000
September 30, 2008	6,000	4,800
December 31, 2008	4,000	6,000

Calculate interest on drawings @ 6%

Effective Drawings Balances

			Rs.
A	Mar 31	4,000 x 9/12 =	3,000
	Jun 30	3,000 x 6/12 =	1,500
	Sep 30	6,000 x 3/12 =	1,500
	Dec 31	4,000 x 0/12 =	0
			6,000
Interest on drawings		**6,000 x 6%**	**360**

Effective Drawings Balances:

			Rs.
B	Mar 31	6,000 x 9/12 =	4,500
	Jun 30	2,000 x 6/12 =	1,000
	Sep 30	4,800 x 3/12 =	1,200
	Dec 31	6,000 x 0/12 =	0
			6,700
Interest on drawings		**6,700 x 6%**	**402**

Changes in constitution of partnership firm

Subsequent to the formation of a partnership firm, a different accounting treatment is required when any of the following changes occur in the constitution of the partnership (Partnership deed) these changes might occur because of the following reasons:

- Admission of a new partner
- Retirement of an existing partner
- Death of a partner

Admission of a new partner

A new partner may be admitted for different reasons such as personal influence, need of more capital, or special skills.

At the time of admission of a new partner, certain adjustments are necessary, like:

- Calculation of new profit sharing ratio.
- Calculation and accounting treatment of goodwill
- Revaluation of net assets.

Calculation of New Profit Sharing Ratio

Basic Data:

Old Ratio A:B
3:2

C is admitted for $1/6^{th}$ share in profits.

Scenario I

A and B will continue sharing in old ratio (mutual ratio would not change).

Scenario II

A and B will share equally after C's admission.

Scenario III

C will buy his share half from A and half from B.

Solution Scenario I

A and B's Share $= 1 - \frac{1}{6} = 5/6$

A $= \frac{5}{6} \times \frac{3}{5} = \frac{3}{6}$

B $= \frac{5}{6} \times \frac{2}{5} = \frac{2}{6}$

C $= \frac{1}{6} = \frac{1}{6}$

New Ratio of A, B and C = 3 : 2 : 1

Solution Scenario II

A $= \frac{5}{6} \times \frac{1}{2} = \frac{5}{12}$

B $= \frac{5}{6} \times \frac{1}{2} = \frac{5}{12}$

C $= \frac{1}{6} \times \frac{2}{2} = \frac{2}{12}$

New ratio of A, B and C = 5 : 5 : 2

Solution Scenario III

Profit of C's Share $= \frac{1}{6} \times \frac{1}{2} = \frac{1}{12}$

A $= \frac{3}{5} - \frac{1}{12} = \frac{31}{60}$ (through LCM)

B $= \frac{2}{5} - \frac{1}{12} = \frac{19}{60}$ (through LCM)

C $= \frac{1}{12} + \frac{1}{12} = \frac{2}{12} \times \frac{5}{5} = \frac{10}{60}$

New ratio of A, B and C = 31 : 19 : 10

Goodwill

Goodwill may arise from such attributes of a business; as good reputation, good customer relationship, strategic location, skills of its employees, dynamic management, durability of its products, effective advertisement, patented manufacturing process, outstanding credit rating, training program of the employees, and good relationship with suppliers and employees, etc.

Goodwill may be described as the aggregate of those intangible attributes of a business that contribute to the superior earning capacity of the business. Goodwill is the outcome of an impression created in the mind of each customer and related persons.

Valuation of Goodwill

Methods to be adopted in valuing goodwill will depend upon the circumstances of each particular case. At the time of valuation of goodwill, the partnership deed should be examined and valuation should be undertaken in accordance with the agreement.

Goodwill Calculation methods

1. Average profit method
2. Super profit method
3. Market capitalization method

Average Profit Method

Under this method, at first, average profit is calculated on the basis of the past few years' profits. At the time of calculating average profit, precaution must be taken in respect of any abnormal items of profit or loss which may affect future profit. It should be mentioned that average profit is based on simple average method.

After calculating average profit, it is multiplied by a number (times) 3, or 4, or 5, whatever, as agreed. The product will be the value of the goodwill.
For example:

Goodwill is three times of the average profit of previous five years.
Let's suppose:

Average profit = 100 / 5 = 20

Goodwill = 20 x 3 = 60

Practice 16.4

Years	**Profit Rs.**
1st year	20,000
2nd year	40,000
3rd year	50,000
4th year	70,000
Total	**180,000**

Goodwill of the firm is equal to three years purchase of the last four years average profits:
Average profit = 180,000 / 4 = Rs. 45,000
Goodwill = 45,000 x 3 = 135,000

In case, **one of the previous years in the formula is showing loss**; such loss shall be subtracted form total profits and then its average will be calculated

Practice 16.5

Year	Profit / Loss (Rs)
1st	30,000
2nd	40,000
3rd	(10,000)
4th	60,000
	120,000

Average Profit = 120,000 / 4 = Rs. 30,000

Number of years for calculating average profit and number of purchase of the average profit for calculating goodwill are determined by experts at the time of preparing partnership agreements.

Super Profit Method

Super profit is the excess of actual profit (average profit) over the normal profit of an entity. A common method of valuation of goodwill is the super profit method. A business unit may possess some advantages which enable it to make extra profits over and above the amount that would be earned if the capital of the business was invested elsewhere with similar risks. These extra profits, generally expressed as super profits, are used to calculate goodwill of the firm.

In this method, super profits are taken as the base for calculating goodwill in place of average profit.

Certain steps are followed in calculating goodwill under super profit method, these are as under:

1. Calculate Capital of the firm
2. Calculate normal profit by multiplying firm's capital with normal rate of return
3. Calculate average profit of the firm
4. Calculate super profit by subtracting normal profit from the average profit
5. Multiply the super profit by the number of year's purchase (number of times)
6. The product will be goodwill.

Practice 16.6

Normal profit = 200,000 x 18% = 36,000

Super profit = Average profit – Normal profit

= 45,000 – 36,000 = 9,000

Goodwill = 9,000 x 3 = 27,000

Market Capitalization Method

Under this method value of the firm is first determined based on market capitalization rate using the following formula:

$$\frac{\text{Average profit of the firm}}{\text{market rate of return}} \times 100$$

The above formula will give an estimate of firm's value in the market. By subtracting book value of the net assets (owners' equity) of the firm from above calculated value we shall get the amount of goodwill.

Practice 16.7

Average profit of the firm is Rs.45,000 and market rate of return is 18% and capital (net assets) of the firm is Rs.200,000.

Good will of the firm will be calculated as under:

Goodwill $= \frac{45{,}000}{18} \times 100 = 250{,}000$

$= 250{,}000 - 200{,}000$

$= 50{,}000$

Accounting treatment for goodwill

Since the goodwill of a partnership firm belongs to the old partners and none else, it is obvious that some adjustments must be made to the capital accounts of old partners upon admission of a new partner so that the incoming partner will not enjoy the goodwill belonging to old partners without payment for that, apart from capital contribution. The amount that incoming partner pays for goodwill is known as premium for goodwill. This goodwill premium is treated in the books of accounts in any of the following manner:

Scenario-1 - Goodwill Raised and Retained as Asset

When the incoming partner cannot bring cash as premium for goodwill

Here, capital accounts of old partners are artificially inflated towards the respective right in firm's goodwill, without any cash contribution. Goodwill is recognized as asset because at present the net assets of the firm can realize more than their fair value. Old partners' capital accounts are credited because new coming partner should not be benefited for such gain, which belongs to the period in which he/she was not among the then partners.

In this case, goodwill account is to be raised in the books of account at its full value by debiting the goodwill account and crediting the old partners' capital accounts in old ratio.

Journal Entry

	Rs.	Rs.
Goodwill A/c	135,000	
A's capital A/c		81,000
B's capital A/c		54,000

Working

A's share = 135,000 x 3/5 = 81,000
B's share = 135,000 x 2/5 = 54,000

Important Tips To Remember (ITTRs)

Following should be taken into account when doing the above treatment for goodwill:

1. If goodwill already appears in the SFP (Balance Sheet), which is equal to the full value of goodwill so calculated, then no entry is required to be passed.
2. if goodwill already appears in the SFP (Balance Sheet), which is less than the full value of goodwill then goodwill is to be raised for the balance (full value of goodwill calculated less goodwill already appearing in the SFP (Balance Sheet).
3. if goodwill already appears in the SFP (Balance Sheet), which is more than the full value of goodwill, then excess goodwill is to be written off. The journal entry will be as under:

Old partners' capital accounts	Dr
Goodwill accounts	Cr

(Being the value of the goodwill written down to its calculated value)

Scenario-2 - Goodwill Raised and Written-Off

When incoming partner cannot bring resources as premium for goodwill but no goodwill is to appear in the books:

Since the value of the goodwill constantly changes and partners may not wish that an account should remain in the books, goodwill is raised in the books first and, thereafter it is written off.

Journal Entry (Goodwill raised)

		Rs.	Rs.
Goodwill A/c		135,000	
	A's capital A/c		81,000
	B's capital A/c		54,000
(Old ratio 3:2)			

Journal Entry (Goodwill raised & written off)

		Rs.	Rs.
A's capital A/c		67,500	
B's capital A/c		45,000	
C's capital A/c		22,500	
	Goodwill A/c		135,000
(New ratio 3:2:1)			

A's benefit	**Rs.**
Old ratio (Cr)	81,000
New ratio (Dr)	67,500
(Cr)	13,500

B's benefit	**Rs**
Old ratio (Cr)	54,000
New ratio (Dr)	45,000
(Cr)	9,000

A's benefit + B's benefit
13,500 + 9,000 = 22,500
C's share = 22,500
C's share = 135,000 x 1/6 = 22,500

Scenario-3 - Goodwill Premium Brought in Cash

When required amount of goodwill premium is brought in by the incoming partner and the money is retained in the business to increase the cash resources:

In this situation, premium for goodwill is to be shared by old partners in sacrificing ratio. The sacrificing ratio is calculated by deducting the new ratio from the old ratio for each partner. It should be noted that when profit sharing ratio between the old partners does not change as between themselves, the old profit sharing ratio would be their sacrificing ratio.

Goodwill premium brought in cash

	Rs.	Rs.
Bank A/c	22,500	
Goodwill premium A/c		22,500

Distribution of goodwill premium (sacrifice ratio)

	Rs.	Rs.
Goodwill Premium A/c	22,500	
A's capital A/c		13,500
B's capital A/c		9,000

A's share = 22,500 x 3/5 = 13,500
B's share = 22,500 x 2/5 = 9,000

Scenario-4 Goodwill Premium Brought in Cash & Withdrawn

When required amount of goodwill premium is brought in by new partner and this amount is immediately withdrawn by the old partners:

Goodwill premium brought in cash

	Rs.	Rs.
Bank A/c	22,500	
Goodwill Premium A/c		22,500

Distribution of goodwill premium (sacrifice ratio)

	Rs.	Rs.
Goodwill Premium A/c	22,500	
A's capital A/c		13,500
B's capital A/c		9,000

Goodwill premium withdrawn

	Rs.	Rs.
A's capital A/c	13,500	
B's capital A/c	9,000	
Bank A/c		22,500

Partners' Ratios and Accounting entries

Often students confuse in distributing amounts of different accounting entries among partners in old, new or sacrificing/gaining ratio.

Important Tips To Remember (ITTRs)

1. All accounting entries in which only old partner are being debited or credited are distributed among the partners in *old ratio* except the only one entry that relates to the distribution of goodwill premium brought in by the new partner in cash, its distribution is made in *sacrificing/gaining ratio*.
2. All accounting entries in which old plus new partners are being debited or credited are distributed among the partners in *new ratio*.
3. Goodwill premium = Goodwill x New partner's share in profit.

Calculation of sacrificing and gaining ratio

Sacrificing and gaining ratio is calculated by subtracting new ratio from the old ratio. If old ratio is greater than the new ratio the result is sacrificing ratio. If new ratio is greater than the old ratio the result is gaining ratio.

Following solved problem demonstrates how the goodwill premium will be distributed when one partner is sacrificing and the other is gaining.

Practice 16.8

Old Ratio	A:B is 1:1
New Ratio	A:B:C is 1:3:1
Sacrificing and gaining ratio is	A = 3
	B = -1
	Sum 2
Sacrificing Ratio	A:B is $\frac{3}{2} : \frac{-1}{2}$

Goodwill premium of Rs. 10,000 will be divided as follows:

A = 10,000 x 3/2	= 15,000
B = 10,000 x -1/2	= -5,000
	10,000

Accounting entry

Bank a/c	10,000	
Goodwill premium A/c.		10,000

Goodwill premium A/c.	10,000	
B's Capital A/c.	5,000	
A's Capital A/c.		15,000

Revaluation of Assets and Liabilities (Net Asset)

At the time of admission of a new partner or retirement of existing partner, net assets of the firm are revalued to their fair value. Revaluation would cause increase or decrease in the book values. Following accounting entries are recorded for revaluation of net assets:

1. For increase in assets value

Specific asset a/c	Dr	
Revaluation a/c	Cr	

2. For decrease in assets value

Revaluation a/c	Dr	
Specific asset a/c	Cr	

3. For increase in Liabilities value

Revaluation a/c	Dr	
Specific liabilities a/c	Cr	

4. For decrease in Liabilities value

Specific liabilities a/c	Dr	
Revaluation a/c	Cr	

(Revaluation a/c leaves a balance of gain/loss)

5. Incase of gain or revaluation

Revaluation a/c	Dr	
Old partners Capital A/c	Cr	(Old ratio)

6. Incase of loss on revaluation

Old Partners Capital A/c.	Dr	(Old ratio)
Revaluation A/c.	Cr	

Increase or decrease in value of net assets (assets or liabilities) is recognized on the date of any change (admission, retirement etc) in partnership constitution. Management must do revaluation of assets and liabilities because fair value of net assets (assets or liabilities) of the firm is not equal to the book value of the net assets as on the date when change in partnership constitution occurs. Therefore, any gain or loss because of change in fair value of net assets should be adjusted immediately so that such gain or loss does not positively or negatively affect the new coming partner or old partners as the case may be.

Practice 16.9 (Readjustment of Partners' Capital Balance in new profit sharing ratio)

Partners' capital balances are readjusted in their new profit sharing ratio. This readjustment may be based on:

1. Capital balances of the old partners
2. Capital introduced by the new partner
3. Total capital balance of the firm after admission of new partner.

Old partners' capital:

A = Rs.1,212,500
B = Rs.950,000

New partner' capital

C = Rs. 400,000

A and B were sharing profits in 3:2, C was admitted for 1/5 share in profit. After C's admission, the profit sharing ratio is 12:8:5 for A, B and C respectively.
Readjust the capital balances of A, B & C in new profit sharing ratio assuming the above three bases.

Answer

			Rs.
	A & B's Capital	12/25	A = 1,297,500
Base 1.	2,162,500 x $\frac{5}{4}$ = 2,703,125	8/25	B = 865,000
		5/25	C = 540,625
			2,703,125
	C's Capital	12/25	A = 960,000
Base 2.	400,000 x $\frac{5}{1}$ = 2,000,000	8/25	B = 640,000
		5/25	C = 400,000
			2,000,000
	Combined Capital (A, B & C)	12/25	A = 1,230,000
Base 3.	2,562,500 x $\frac{1}{1}$ = 2,562,500	8/25	B = 820,000
		5/25	C = 512,500
			2,562,500

Retirement of a Partner

When a partner intends to retire; his/her capital account balance after adjustments for share in goodwill and revaluation gains or losses is recognized as loan (liability) to the entity.

Death of a Partner

At the time of death of a partner, his/her share in current years' profits is estimated based on previous year's net profit or average profit of past few years' profits (it would be mentioned in partnership agreement).

The partnership agreement would also state whether the deceased partner would be entitled to share in goodwill, interest on capital etc. or not.

Deceased partner's executor's account is credited with his/her capital balance, share in profits, share in goodwill interest on capital and any other items to be specified like "loan to or from the firm". This account is debited with the deceased partner's drawings, interest on drawings or any account recoverable from him.

Credit balance of this account would be a liability of the firm and in case of debit balance it would be an asset.

<u>Important Tips to Remember (ITTRs)</u>

1. On the date of change like change in profit sharing arrangements, admission, retirement or death, any amount appearing as un-appropriated profits, profit/loss account balance or Reserves Account will be transferred to those partners' capital accounts who were partners before such change took place, in their respective profit sharing ratio (old ratio).

2. New Partnership constitution may require not to alter values of respective net assets although those have been revalued. In this case a revaluation memorandum a/c will be prepared to calculate gain/loss on revelation such gain or loss shall be firstly divided among old partners in old profit sharing ratios and then the same amount of gain or loss shall be reversed among the new partners in the new profit sharing ratios. Say the gain on such revaluation was Rs. 450,000, its accounting entry would be

A's Capital (old partner)	2/5	180,000	
B's Capital (old partner)	2/5	180,000	
C's Capital (new partner)	1/5	90,000	
A's Capital (old partner)	4/5		360,000
B's Capital (old partner)	1/5		90,000

Old ratio (4 : 1) new ratio (2 : 2 : 1)

This will be the only accounting entry that would be recorded in case of revaluation of assets and liabilities, subject to the decision that their values will remain unaltered.

As none of the assets or liabilities is being debited or credited in this accounting entry, therefore value of each asset and liability would remain same as those were appearing in the Statement of Financial Position (Balance Sheet) before the change in Partnership constitution took place.

3. When one partner is being retired and another partner is being admitted on the same date, special care must be taken while identifying old and new profit sharing ratios.

For example A:B:C were partners sharing profit 3:2:5 respectively C retires and D was admitted for 1/6th share in profits then A:B:D would be 3: 2 : 1

$$A = \frac{5}{6} \times \frac{3}{5} = \frac{3}{6}$$

$$B = \frac{5}{6} \times \frac{2}{5} = \frac{2}{6}$$

$$D = \frac{1}{6}$$

For A, B and C old ratio is 3 : 2 : 5 and new ratio is A : B i.e. 3 : 2

For A, B and D old ratio is A : B = 3 : 2 and new ratio is 3 : 2 : 1

4. At the time of D's admission, the new ratio after C's retirement would become old ratio.

5. When a retiring partner agrees to takeover a liability, the specific liability account is debited and retiring partner's capital account is credited.

6. The final balance of retiring partner's capital account is paid in cash, but if sufficient cash balance is not available then he/she may also be allowed to takeover one or more assets of the firm for which the specific asset/s account will be credited and partner's capital account will be debited. Such takeover is settled at fair value and any difference in value is transferred (Dr./Cr.) to the revaluation account. Revaluation of the assets / liabilities taken over should be done before determining the final capital balance of the retiring partner.

Practice 16.9 **(Final Accounts of Partnership Firm)**

Shezra and Sumaiya are partners in a trading business, sharing profit and losses in the ratio 3:2. The Trial Balance of the firm on 31st March, 20Y0 was as follows:

Trial Balance as on 31st March, 20Y0

Debit Balances	**(Rs.)**	**Credit Balances**	**(Rs.)**
Opening stock	2,000	Capital account – Shezra	10,000
Purchases	148,000	Capital account – Sumaiya	10,000
Trade Debtors	12,000	Sales	220,000
Wages sales staff	5,000	Trade Creditors	21,000
Salaries administrative staff	10,000	Bills payable	20,000
Building	30,000	Discount	6,500
Machinery	25,000		
Furniture	16,000		
Advertisement (for 2 years)	6,000		
Bills Receivable	8,000		
Insurance premium	2,000		
Drawings – Shezra	2,000		
Drawings – Sumaiya	3,000		
Cash in hand	5,500		
Repair and maintenance	10,000		
Utility bills	3,000		
	287,500		**287,500**

Adjustments:

1. Stock on hand on 31st March, 20Y0 was at Rs.5,000.
2. Write off Rs.2,000 for further Bad debts and maintain provision for doubtful debts at 5% on debtors.
3. Depreciate Building at 5%, Machinery at 10% and furniture at 10%
4. Outstanding expenses were wages Rs.2,000 and salary Rs.1,000.
5. Prepaid repair Rs.1,600
6. Credit purchases amounted to Rs.4,000 were not recorded in the books of account.
7. It was decided that there will be no interest on capital and drawings.
8. Both partners are entitled to annual salary; Shezra Rs.15,000, Sumaiya Rs.10,000.

From the above Trial Balance and adjustments prepare Income Statement for the year ended 31st March, 20Y2 and Balance Sheet as on that date.

Answer

Shezra and Sumaiya
Income Statement
for the year ended 31st March, 20Y2

	Rs.	Rs.	Rs.
Sales			220,000
Cost of goods sold			
Opening stock		2,000	
Purchases	148,000		
Un recorded credit purchases	4,000	152,000	
Closing stock		-5,000	149,000
Gross profit			**71,000**
Other income – Discount received			6,500
Operating expenses			
Wages – sales staff	5,000		
Outstanding wages	2,000	7,000	
Salaries – administrative staff	10,000		
Outstanding salaries	1,000	11,000	
Advertisement	6,000		
Prepaid advertisement	-3,000	3,000	
Insurance		2,000	
Repair and maintenance	10,000		
Prepaid repair	-1,600	8,400	
Utility bills		3,000	
Depreciation			
Building	1,500		
Machinery	2,500		
Furniture	1,600	5,600	
Bad debts	2,000		
Increase in provision for doubtful debts	500	2,500	42,500
Net profit before distribution to partners			35,000

Profit Distribution Statement
For the year ended 31st March 20Y2

	Shezra Rs.	Sumaiya Rs.	Total Rs.
Net profit			35,000
Partners salaries	15,000	10,000	-25,000
			10,000
Profit ratio			
Shezra 10,000 x 3/5	6,000		
Sumaiya 10,000 x 2/5		4,000	-10,000
	21,000	**14,000**	**Nil**

Shezra and Sumaiya
Balance Sheet
As at 31st March 20Y2

	Rs.	**Rs.**	**Rs.**
Non-Current Assets			
Building	30,000		
Depreciation	1,500	28,500	
Machinery	25,000		
Depreciation	2,500	22,500	
Furniture	16,000		
Depreciation	1,600	14,400	65,400
Current Assets			
Closing stock		5,000	
Trade Debtors	12,000		
Further bad debts	-2,000		
Provision for doubtful debts	-500	9,500	
Prepaid advertisement		3,000	
Prepaid repair		1,600	
Bills receivable		8,000	
Cash in hand		5,500	32,600
			98,000
Owners' Equity			
Shezra's Capital	10,000		
Shezra's Profit share	21,000		
Shezra's Drawings	-2,000	29,000	
Sumaiya's Capital	10,000		
Sumaiya's Profit share	14,000		
Sumaiya's Drawings	-3,000	21,000	50,000
Liabilities			
Trade creditors	21,000		
Un-recorded purchases	4,000	25,000	
Bills payable		20,000	
Outstanding wages		2,000	
Outstanding salaries		1,000	48,000
			98,000

Practice 16.10 (Final Accounts of Partnership Firm)

Prepare Income Statement and Balance Sheet from the following Trial Balance of Sabaina and Shahzel, for the year ended 31st March, 20Y3. They share profits and losses in their capital ratio.

Trial Balance as on 31st March, 20Y3

Debit Balances	(Rs.)	Credit Balances	(Rs.)
Opening stock	28,000	Capital – Sabaina	80,000
Purchases	116,400	Capital – Shahzel	40,000
Carriage inwards	2,400	Trade Creditors	46,000
Carriage outwards	6,200	Sales	220,000
Salaries and wages	14,800	Provision for doubtful debts	1,800
Advertisement	8,200	Current account – Sabaina	36,000
Utility bills	11,000		
Machinery	44,000		
Furniture	36,000		
Office Rent	4,000		
Motor Van	63,000		
Current account – Shahzel	16,000		
Trade Debtors	40,000		
Cash in hand	32,800		
Bad debts	1,000		
	4,23,800		**4,23,800**

Adjustments:

1. Closing stock was valued at cost Rs.36,000 while its NRV was Rs.40,000.
2. Uninsured goods worth Rs.10,000 were stolen, it is considered as abnormal loss
3. Goods worth Rs.20,000 were sold on credit and delivered on 31st March, 20Y3, but no entry is passed in sales book.
4. Depreciate Machinery at 10%, Motor Van at 15% and Furniture at 10%
5. Create a provision for doubtful debts at 5% on Debtors.
6. Sabaina and Shahzel are entitled to partners' salary of Rs.10,000 and Rs.24,000 respectively.

Answer

Sabaina and Shahzel

Income Statement

For the year ended 31st March, 20Y3

	Rs.	Rs.	Rs.
Sales		220,000	
Un-recorded sales		20,000	240,000
Cost of goods sold			
Opening stock		28,000	
Purchases	116,400		
Goods stolen	-10,000		
Carriage inwards	2,400	108,800	
Closing stock		-36,000	100,800
Gross profit			**139,200**
Operating expenses			
Carriage outwards		6200	
Salaries and wages		14,800	
Advertisement		8,200	
Utility bills		11,000	
Office rent		4,000	
Un-insured loss of stolen goods		10,000	
Depreciation			
Machinery	4,400		
Motor van	9,450		
Furniture	3,600	17,450	
Bad debts	1,000		
Increase in provision for doubtful debts	3,000	4,000	75,650
Net profit before distribution to partners			**63,550**

Profit Distribution Statement

For the year ended 31st March 20Y3

	Sabaina Rs.	Shahzel Rs.	Total Rs.
Net profit			63,550
Partners salaries	10,000	24,000	-34,000
			29,550
Profit ratio			
Sabaina 29,550 x 2/3	19,700		
Shahzel 29,550 x 1/3		9,850	-29,550
	29,700	**33,850**	**Nil**

Partners' Current Account

	Sabaina	Shahzel		Sabaina	Shahzel
Balance b/f		16,000	Balance b/f	36,000	
			Profit share	29,700	33,850
Balance c/f	67,500	17,850			
	65,700	33,850		65,700	33,850

Sabaina and Shahzel
Balance Sheet
As at 31st March 20Y3

	Rs.	Rs.	Rs.
Non-Current Assets			
Machinery	44,000		
Depreciation	4,400	39,600	
Furniture	36,000		
Depreciation	3,600	32,400	
Motor van	63,000		
Depreciation	9,450	53,550	125,550
Current Assets			
Closing stock		36,000	
Trade Debtors	40,000		
Un-recorded sales	20,000		
Provision for doubtful debts	-3,000	57,000	
Cash in hand		32,800	125,800
			251,350
Owners' Equity			
Sabaina's Capital	80,000		
Sabaina's Current account	67,500	147,500	
Shahzel's Capital	40,000		
Shahzel's Current account	17,850	57,850	205,350
Liabilities			
Trade creditors			46,000
			251,350

Exercise and Examination Questions

Question No 1

The draft accounts report a gross profit of Rs.157,846 and a net profit of Rs.51,024. Each partner has withdrawn Rs. 15,000 from the business for personal use.

At 1 May 20X3 the balances on the partners' capital and current accounts were:

	Omni	**Public**
Capital account	Rs.125,000 (credit)	Rs.70,000 (credit)
Current account	Rs.34,568 (credit)	Rs.23,741 (debit)

The partnership agreement includes the following terms:

	Omni	**Public**
Share of profits and losses	2/3	1/3
Salary	Rs.1,500 per month	Rs.1,000 per month
Interest on capital (per annum)	8%	8%

What is the correct amount of owners' equity for each partner?

The partnership agreement also states that the partners' capital account balances will remain fixed

A. Omni Rs. 22,729 & Public Rs. -19,333

B. Omni Rs. 176,184 & Public Rs. 50,667

C. Omni Rs. 191,184 & Public Rs. 65,667

D. Omni Rs. 178,017 & Public Rs. 48,834

Question No 2

Faiqa and Saiqa are in partnership sharing profits and losses in the ratio 3:4. The income statement for the year to 31 May 20X6 reported a net profit of Rs.30,709. Faiqa is entitled to a salary of Rs.14,000 per annum.

What is Saiqa's share of the profit for the year to 31 May 20X6?

A. Rs.7,161

B. Rs.9,548

C. Rs.17,548

D. Rs.25,548

Question No 3

Seemal and Maira are in partnership, sharing profits and losses in the ratio 2:3.

The partnership agreement provides for the following:

Seemal is entitled to a salary of Rs.32,000;

Maira is entitled to a salary of Rs.26,000;

Interest is paid at a rate of 8% per annum on the partners' capital balances at the start of the financial year; and Interest is charged at a rate of 12% per annum on the partners' drawings. At 1 May 20X6, the partners' capital and current account balances were:

	Seemal	**Maira**
Capital	Rs.47,500 (credit)	Rs.34,800 (credit)
Current	Rs.1,680 (debit)	Rs.6,750 (credit)

During the year to 30 April 2007:

Seemal's drawings were Rs.22,800; Maira's drawings were Rs.25,600; and the net profit for the year was Rs.52,952.

What is the correct amount of owners' equity for each partner

A. Seemal Rs. 62,612 & Maira Rs. 31,554

B. Seemal Rs. 44,201 & Maira Rs. 34,221

C. Seemal Rs. 53,780 & Maira Rs. 38,142

D. Seemal Rs. 47,500 & Maira Rs. 34,800

Chapter – 17

Company Financial Statements
(Final Account)

Sr. No	Course Outline Topics
1	Components of Financial Statements - Final Account
2	Statement of Financial Position
3	Statement of Profit or Loss and Other Comprehensive Income
4	Statement of Changes in Equity
5	Practice - Company Final Account
6	Practice - Company Final Account

Topic videos 158-163 are mandatory part of this module

Components of financial statements (final account)

Accounting for company style of business is similar to the other forms of business organizations but reporting requirements are different rather more complex because of the involvement of more stake holders in it.

The owners of a company are its members or shareholders, but a company is managed by its board of directors. In some companies, the directors are major shareholders. In larger companies, the directors may have some shares, but are not the major shareholders. Other shareholders use the annual accounts to assess the performance of their company and its management.

Every company is registered under the statute, which requires that each company should prepare a set of financial statements (final account) at the end of reporting period i.e., normally 12 months.

Final account is the last step involved in accounting cycle. It is maintained with a view to knowing the overall result of a business operation. Final account depicts the results from operations of a business organization and also reflects the financial condition of the business organization during a certain period, in other words; it is prepared to achieve overall objectives of accounting. The operational results are presented in trading and profit and loss account that indicates profit or loss made during a period. Whereas, the financial position is presented in balance sheet showing assets, equity and liabilities of the business organization on a certain date.

Final account is the combination of income statement (trading and profit and loss account) and balance sheet.

Companies are governed by a law prevailing in the country. Therefore, it is a statutory obligation that all companies are required to follow the relevant section of the law that governs the maintaining of accounts.

Most of the countries have adopted IFRS, which requires companies to prepare following set of reports as final account:

1. Statement of Financial Position (Balance Sheet)
2. Statement of Profit or Loss and Other Comprehensive Income (Income Statement)
3. Statement of Changes in Equity
4. Statement of Cash Flows
5. Notes (Accounting Policies and Disclosures of Explanatory Working)

Financial statements are useful for the following reasons:

- To determine the ability of a business to generate cash, and the sources and uses of that cash.
- To determine whether a business has the capability to pay back its debts.
- To track financial results on a trend line to spot any alarming profitability issues.
- To derive financial ratios from the statements that can indicate the condition of the business.
- To investigate the details of certain business transactions, as outlined in the notes

Statement of Financial Position – SoFP (Balance Sheet)

Statement of Financial Position (SoFP) is prepared at a specific date i.e., at the end of reporting period. It presents financial status of the company by presenting recognized assets, equity and liability items. It is customary that the items of SoFP are grouped in a systematic order. Otherwise IFRS does not require specific order to present SoFP.

For a company style of business grouping of assets is done on the basis of permanency order. This is known as marshaling. marshalling

As per IAS 1; the assets are classified into Non-Current Assets and Current Assets. Non-Current Assets are then further sub-classified into fixed and other non-current assets. Fixed assets are then split into fixed tangible and fixed intangible assets.

Fixed Tangible Assets

These are the property, plant and equipment that are held by the entity a) for production or selling of goods or services, b) for administrative purposes, or c) for rental to others.

These are expected to be useful for the entity for more than one accounting year. Examples include: land & Building, Plant & Machinery, Furniture & Fixtures, Motor Vehicles, Office Equipments etc.

Fixed Intangible Assets

These are the identifiable, non-monetary asset in control of the entity that have no physical existence and are expected to be useful for the entity for more than one accounting year. Examples include: Trademark, Copyright, Patents and Designs etc.

Long term Investment

These are the investments made by the company in other entities for more than one accounting year. Examples include: Investments in equity instruments or debt securities of other entities.

Long term loans

These are the loans given to the third parties on long term basis, receivable after the expiry of more than one accounting year.

Long term advances, deposits, and prepayments

These are the security deposits, fixed deposits, advances given to the suppliers of assets, and prepayments on long term basis.

Current Assets

These are the assets recoverable and tradable within the normal operating cycle of an entity that is 12 months after the reporting date in normal circumstances. Cash and cash equivalents are also current assets.

Current Liabilities

These are the present obligations of the entity that are payable within the normal operating cycle of an entity that is 12 months after the reporting date in normal circumstances. These also include bank overdraft and short-term debts.

Non-Current Liabilities

These are the present obligations of the entity that are payable after one or more than one accounting year. These include; lease liabilities, bank loans, issuance of loan certificates and bonds.

Owners' Equity

It is the residual interest in assets of the entity after deducting its liabilities. Owners' equity is the source of finance that represents owners' stake in the entity. It includes; share capital and reserves.

Format

<u>**Company's Name**</u>
Statement of Financial Position (Balance Sheet)
As at December 31, 20X9

	Rs.	*Rs.*
RESOURCES		
Non-Current Assets		
Fixed Assets		
Tangible Assets – (IAS 16)	***	
Intangible Assets – (IAS 38)	***	***
Investment Properties – (IAS 40)		***
Long Term Financial Assets – (IFRS 9)		***
(Investments in Equity/Debt, Deposits, Prepayments, Loans & Receivables)		
Total Non-Current Assets		***
Current Assets		
Inventories – (IAS 2)	***	
Accounts Receivables & Accruals – (IFRS 9)	***	
Short Term Investments & Prepayments – (IFRS 9)	***	
Cash and Bank Balances – (IFRS 9)	***	***
Current Liabilities		
Accounts Payable & Accruals – (IAS 39)	***	
Short Term Loans – (IAS 39)	***	
Current portion of lease liability – (IAS 17)	***	
Current portion of long term loans – (IFRS 9)	***	
Provisions against expected losses – (IAS 37)	***	
Provisions for current tax – (IAS 12)	***	
Bank Overdraft – (IFRS 9)	***	(***)
Working Capital		***
Capital Employed (Non-Current Assets + Working Capital)		*******
FINANCED BY – SOURCES/CLAIMS		
Owners' Equity (Owned source)		
Ordinary Share Capital/Common Stocks – (IAS 32)	***	
Other Components of Equity – (IAS 32)	***	
Share Premium – (IAS 32)	***	
Revaluation Reserve – (IAS 16)	***	
Plant Replacement Reserve – (IAS 32)	***	
Dividend Equalization Reserve – (IAS 32)	***	
Any other named Reserve – (IAS 32)	***	
General Reserves – (IAS 32)	***	
Retained Earnings – (IAS 32)	***	***
Non-Current Liabilities		
Loan Stocks/Bonds/Preferred Shares – (IAS 39)	***	
Loan from financial institutions – (IAS 39)	***	
Lease liability – (IFRS 16)	***	
Defined Benefit Plan Obligation <u>*Less*</u> Plan Asset – (IAS 19)	***	
Deferred Tax Liability – (IAS 12)	***	***
Capital Employed (Owners' Equity + Non-Current Liabilities)		*******

<u>*Approved by Chief Executive and a Director*</u>

Statement of Profit or Loss and Other Comprehensive Income (Income Statement)

Income Statement is prepared to know the financial performance of an entity. In an Income Statement; expenses for the year are subtracted from the incomes earned during the year. Both incomes and expenses are measured based on the accrual concept, whereas, profit is measured based on the matching concept.
According to the IAS 1 Income Statement can be prepared using either:

1. Function of expenses method, or
2. Nature of expenses method

Function of expenses method
This method is mostly followed by the accountants to prepare and present Income Statement. In this method the expenses are divided into five groups:

- Cost of sales
- Administrative
- Selling and marketing
- Financial
- Income Tax

Incomes are also divided into two groups:

- Sales revenue (operating income)
- Other incomes (non-operating incomes)

Profit after tax is subsequently clubbed with other comprehensive income (unrealized gain/loss) that ultimately shows Total Comprehensive Income for the reporting period of the entity (both realized and unrealized).

Other Comprehensive Income (OCI) is integral part of Income Statement, which presents unrealized gains and losses occurred during the year. These unrealized gains and losses are further categorized into two:

- Items that will not be reclassified to Income Statement (Profit or Loss)
- Items that may be reclassified subsequently to Income Statement (Profit or Loss)

Format

<u>Company's Name</u>

Statement of Profit or Loss and Other Comprehensive Income (Income Statement)

For the Year ended December 31, 20X9

	Rs.	***Rs.***
Sales revenue – (IFRS 15)		***
Cost of goods sold – (IAS 2)		(***)
Gross profit		***
Operating expenses – (IAS 1, 16, 36, 38, 37, 40, IFRS 2)		
Administrative expense	***	
Selling & Marketing expenses	***	(***)
Profit from operations		***
Other income – (IAS 11, 16, 20, 40, IFRS 9, 15)		***
Financial expenses – (IAS 23, IFRS 9, 16)		(***)
Profit before tax		***
Income tax expense – (IAS 12)		(***)
Profit after tax		***

Statement of Other Comprehensive Income

For the Year ended December 31, 20X9

Profit after tax		***
Items that will not be reclassified to Income Statement (Profit or Loss)		
Gain on Revaluation of Property Plant & Equipment – (IAS 16)	***	
Re-measurement of Investments in Equity – (IFRS 9)	***	
Actuarial gain/loss on defined benefit plan – (IAS 19)	***	***
Items that may be reclassified subsequently to Income Statement (Profit or Loss)		
Foreign exchange gain/loss on translating foreign operations – (IAS 21)	***	
Cash flow Hedges – effective part – (IFRS 9)	***	***
Total Comprehensive Income		***

<u>Approved by Chief Executive and a Director</u>

Statement of changes in equity

Statement of profit or loss and other comprehensive income shows all non-owner changes in equity. Whereas, the statement of changes in equity concentrates on showing all owner changes in equity.

IAS 1 requires a statement of changes in equity should present:

1. Total comprehensive income for the period, showing the amounts attributable to owners
2. The effects of retrospective application or restatement as a result of a change in accounting policy under IAS 8.
3. For each component of equity, a reconciliation between the carrying amount at the beginning and end of the period, separately disclosing changes resulting from:
    a. profit or loss
    b. each item of other comprehensive income; and
    c. transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners

Company's Name
Statement of changes in equity
For the year ended December 31, 20X9

	Share Capital	Share Premium	Revaluation Reserve	Accumulated OCI*	Retained Profits	Total
Opening Balance	***	***	***	***	***	***
Fresh issue of shares	***	***				***
Revaluation of assets			***			***
Transferred upon disposal			(***)		***	
For the year (after tax)				***	***	***
Dividend paid during the year					(***)	(***)
Bonus Share	***	(***)			(***)	-
Totals	***	***	***	***	***	***

Approved by Chief Executive and a Director

***Accumulated Other Comprehensive Income (OCI)**

Accumulate OCI is a general ledger account that is classified within the equity section of the balance sheet. It is used to accumulate unrealized gains and unrealized losses on those line items in the income statement that are classified within the OCI category with the exception of revaluation reserve under IAS 16 (PPE).

A transaction is unrealized when it has not yet been settled. Thus, if investment is made in a financial asset subject to remeasurement at Fair Value through OCI, any gain or loss at its fair value is presented in OCI until the investment is sold, at which time the gain or loss would be realized.

The unrealized gains and losses that may be aggregated into the accumulated OCI account include:

- *Unrealized holding gains or losses on investments that are subject to remeasurement at FVTOCI*
- *Defined Benefit Pension plan: Actuarial gains or losses*
- *Foreign exchange gains or losses on translating foreign operations*
- *Cash flow Hedges – effective part*

OCI is split into two parts:

1. *Items that will not be reclassified to Income Statement; once a gain or loss of the items in this part is realized, it is shifted out of the accumulated OCI account and posted to the retained earnings account.*
2. *Items that may be reclassified subsequently to Income Statement; once a gain or loss of the items in this part is realized, it is shifted out of the accumulated OCI account and posted as a separate line item in the income statement.*

The example given by IAS 1 revised is as follows.

XYZ GROUP – STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER

	20X7	*20X6*
Assets	$'000	$'000
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Available-for-sale financial assets	142,500	156,000
	901,620	945,460
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	312,400	322,900
	564,880	578,740
Total assets	1,466,500	1,524,200
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	161,700
Other components of equity	10,200	21,200
	903,700	782,900
Non-controlling interest	70,050	48,600
Total equity	973,750	831,500
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
Total non-current liabilities	117,650	238,280
Current liabilities		
Trade and other payables	115,100	187,620
Short-term borrowings	150,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
Total current liabilities	315,100	454,420
Total liabilities	492,750	692,700
Total equity and liabilities	1,466,500	1,524,200

XYZ GROUP – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7	*20X6*
	$'000	$'000
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
*Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain(loss) on property revaluation of associates	400	(700)
Income tax relating to items that will not be reclassified	5,834	(7,667)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss		
* Exchange differences on translating foreign operations	5,334	10,667
*Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
Total comprehensive income for the year	107,250	93,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interest	24,250	13,100
	121,250	65,500
Total comprehensive income attributable to		
Owners of the parent	85,800	74,800
Non-controlling interest	21,450	18,700
	107,250	93,500
Earnings per share (in currency units)	0.46	0.30

XYZ GROUP – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital	*Retained earnings*	*Available for-sale financial assets*	*Revaluation surplus*	*Total*	*Non-controlling interest*	*Total equity*
	$'000	$'000	$'000	$'000	$'000	$'000	$'000
Balance at 1 January 20X6	600,000	118,100	1,600	–	719,700	29,800	749,500
Changes in accounting policy	–	400	–	–	400	100	500
Restated balance	600,000	118,500	1,600	–	720,100	29,900	750,000
Changes in equity							
Dividends	–	(10,000)	–	–	(10,000)	–	(10,000)
Total comprehensive income for the year	–	53,200	16,000	1,600	70,800	18,700	89,500
Balance at 31 December 20X6	600,000	161,700	17,600	1,600	780,900	48,600	829,500
Changes in equity for 20X7							
Issue of share capital	50,000	–	–	–	50,000	–	50,000
Dividends	–	(15,000)	–	–	(15,000)	–	(15,000)
Total comprehensive income for the year	–	96,600	(14,400)	800	83,000	21,450	104,450
Transfer to retained earnings	–	200	–	(200)	–	–	–
Balance at 31 December 20X7	650,000	243,500	3,200	2,200	898,900	70,050	968,950

Note that where there has been a change of accounting policy necessitating a retrospective restatement, the adjustment is disclosed for each period. So, rather than just showing an adjustment to the balance b/f on 1.1.X7, the balances for 20X6 are restated.

Practice 17.1

The accountant of Pestle Cement Company Limited has prepared the following trial balance on 31st December 20X9.

Accounting Heads	Rs. (000)	Rs. (000)
Share capital		550
Share premium		100
Revaluation reserve		125
Retained earnings		563
Land and buildings (carrying value)	678	
Plant and machinery (carrying value)	585	
Inventory 1 Jan 20X9	120	
Sales revenue		925
Purchases	512	
Administration expenses	102	
Marketing expenses	165	
Financial expenses	42	
Trade receivables	300	
Cash balance	45	
Trade payables		286
Total	**2,549**	**2,549**

Further information:

a. Inventory at 31 December 20X9 amounted to Rs.235,000
b. The taxation expense for the year is estimated to be Rs.62,000 create provision.
c. The revaluation reserve relates to land that was revalued during the year.

Required

Prepare for the year ended 31 December 20X9:

1. Statement of Profit or Loss and Other Comprehensive Income
2. Statement of Changes in Equity
3. Statement of Financial Position as on that date

Pestle Cement Company
Statement of Profit or Loss and Other Comprehensive Income (Income Statement)
For the Year ended December 31, 20X9

	Rs. (000)	Rs. (000)
Sales revenue		925
Cost of goods sold		
Opening inventory	120	
Purchase	512	
Closing inventory	(235)	(397)
Gross profit		528
Operating expenses		
Administrative expense	102	
Selling & Marketing expenses	165	(267)
Profit from operations		261
Other income		0
Financial expenses		(42)
Profit before tax		219
Income tax expense		(62)
Profit after tax		**157**

Statement of Other Comprehensive Income
For the Year ended December 31, 20X9

Profit after tax		157
Items that will not be reclassified to Income Statement (Profit or Loss)		
Gain on Revaluation of Property Plant & Equipment	125	
Re-measurement of Investments in Equity	0	125
Items that may be reclassified subsequently to Income Statement (Profit or Loss)		
Foreign exchange gain/loss on translating foreign operations	0	
Cash flow Hedges – effective part	0	0
Total Comprehensive Income		**283**

Pestle Cement Company
Statement of changes in equity
For the year ended December 31, 20X9

	Share Capital	Share Premium	Revaluation Reserve	Accumulated OCI	Retained Profits	Total
Opening Balance	550	100	0	0	563	1,231
Fresh issue of shares	0	0				0
Revaluation of assets			125			125
For the year (after tax)				0	157	157
Dividend paid during the year					(0)	(0)
Total	**550**	**100**	**125**	**0**	**720**	**1,495**

Pestle Cement Company
Statement of Financial Position (Balance Sheet)
As at December 31, 20X9

	Rs.	*Rs.*
RESOURCES		
Non-Current Assets		
Fixed Assets		
Land & Building	678	
Plant & Machinery	585	1,263
Total Non-Current Assets		1,263
Current Assets		
Inventories	235	
Trade Receivables	300	
Cash and Bank Balances	45	580
Current Liabilities		
Accounts Payable	286	
Provisions for current tax	62	(348)
Working Capital		232
Capital Employed (Non-Current Assets + Working Capital)		**1,495**
FINANCED BY – SOURCES/CLAIMS		
Owners' Equity		
Ordinary Share Capital/Common Stocks	550	
Share Premium	100	
Revaluation Reserve	125	
Retained Earnings	720	1,495
Non-Current Liabilities		
Loan Stocks/Bonds/Preferred Shares	0	
Deferred Tax Liability	0	0
Capital Employed (Owners' Equity + Non-Current Liabilities)		**1,495**

Practice 17.2

The accountant of Rose Syrup Company Limited has prepared the following trial balance on 31st December 20X9.

Accounting Heads	Rupees	Rupees
Share capital		550
Share premium		100
Revaluation reserve		125
Retained earnings		563
Accumulated other comprehensive income		180
Short term investments	200	
Long term investments	500	
Lease liability		270
8% loan stocks		250
Land and buildings (carrying value)	678	
Plant and machinery (carrying value)	585	
Inventory 1 Jan 20X9	120	
Sales revenue		925
Purchases	512	
Administration expenses	102	
Marketing expenses	165	
Financial expenses	42	
Trade receivables	300	
Cash balance	25	
Dividend paid	20	
Trade payables		286
Total	**3,249**	**3,249**

Further information:

a. Inventory at 31 December 20X9 amounted to Rs.235.
b. Short term investments are remeasured at fair value Rs.280 through profit or loss.
c. Long term investments are remeasured at fair value Rs.600 through OCI.
d. Lease liability includes Rs.50 representing current portion.
e. The taxation expense for the year is estimated to be Rs.62, assuming no tax effect on fair value gain or loss resulting from re measurement of investments.
f. The revaluation reserve relates to land that was revalued during the year.
g. Full year interest on loan stocks has already been paid in cash.

Required

Prepare for the year ended 31 December 20X9:

1. Statement of Profit or Loss and Other Comprehensive Income
2. Statement of Changes in Equity
3. Statement of Financial Position as on that date

Rose Syrup Company
Statement of Profit or Loss and Other Comprehensive Income (Income Statement)
For the Year ended December 31, 20X9

	Rs.	Rs.
Sales revenue		925
Cost of goods sold		
Opening inventory	120	
Purchase	512	
Closing inventory	(235)	(397)
Gross profit		528
Gain on remeasurement of short term investments		80
Operating expenses		
Administrative expense	102	
Selling & Marketing expenses	165	(267)
Profit from operations		341
Other income		0
Financial expenses		(42)
Profit before tax		299
Income tax expense		(62)
Profit after tax		**237**

Statement of Other Comprehensive Income
For the Year ended December 31, 20X9

Profit after tax		237
Items that will not be reclassified to Income Statement (Profit or Loss)		
Gain on Revaluation of Property Plant & Equipment	125	
Re-measurement of Long term investments	100	225
Items that may be reclassified subsequently to Income Statement (Profit or Loss)		
Foreign exchange gain/loss on translating foreign operations	0	
Cash flow Hedges – effective part	0	0
Total Comprehensive Income		**462**

Rose Syrup Company
Statement of changes in equity
For the year ended December 31, 20X9

	Share Capital	Share Premium	Revaluation Reserve	Accumulated OCI*	Retained Profits	Total
Opening Balance	550	100	0	180	563	1,393
Fresh issue of shares	0	0				0
Revaluation of assets			125			125
For the year (after tax)				100	237	337
Dividend paid during the year					(20)	(20)
Total	**550**	**100**	**125**	**280**	**780**	**1,835**

Rose Syrup Company
Statement of Financial Position (Balance Sheet)
As at December 31, 20X9

	Rs.	*Rs.*
RESOURCES		
Non-Current Assets		
Fixed Assets		
Land & Building	678	
Plant & Machinery	585	1,263
Long term investments		600
Total Non-Current Assets		1,863
Current Assets		
Inventories	235	
Trade Receivables	300	
Short Term Investment	280	
Cash and Bank Balances	25	840
Current Liabilities		
Accounts Payable	286	
Current portion of lease liability	50	
Provisions for current tax	62	(398)
Working Capital		442
Capital Employed (Non-Current Assets + Working Capital)		**2,305**
FINANCED BY – SOURCES/CLAIMS		
Owners' Equity		
Ordinary Share Capital	550	
Share Premium	100	
Revaluation Reserve	125	
Accumulated Other Comprehensive Income	280	
Retained Earnings	780	1,835
Non-Current Liabilities		
8% Loan Stocks	250	
Lease liability	220	
Deferred Tax Liability	0	470
Capital Employed (Owners' Equity + Non-Current Liabilities)		**2,305**

MCQs

1. Which of the following shall appear in a company's statement of changes in equity?

1. Profit on disposal of properties.
2. Surplus on revaluation of properties
3. Equity dividends proposed after the reporting date.
4. Issue of share capital.

A. 1, 3 and 4 only
B. 2 and 4 only
C. 1 and 2 only
D. 3 and 4 only

2. At 31 December 20X2 the following matters require inclusion in a company's financial statements:

1. On 1 January 20X2 the company made a loan of Rs.12,000 to an employee, repayable on 30 April 20X3, charging interest at 2 per cent per annum. On the due date she repaid the loan and paid the whole of the interest due on the loan to that date.
2. The company has paid insurance Rs.9,000 in 20X2, covering the year ending 31 August 20X3.
3. In January 20X3 the company received rent from a tenant Rs.4,000 covering the six months to 31December 20X2.

For these items, what amount should be included in the company's statement of financial position at 31 December 20X2?

	Current assets	Current liabilities
	Rs.	Rs.
A.	22,000	240
B.	**22,240**	**NIL**
C.	20,240	NIL
D.	10,000	12,240

3. At 1 January 200X6, a company's capital structure was as follows:

	Rs.
Ordinary share capital	
20,000 shares of Rs.100 each	2,000,000
Share premium account	1,400,000

In January 20X6 the company issued 10,000 shares at Rs.140 each.

What were the balances on the company's share capital and share premium accounts after these transactions?

	Share capital	Share premium
A	4,000,000	800,000
B	3,400,000	1,400,000
C	**3,000,000**	**1,800,000**
D	2,000,000	2,800,000

CHAPTER – 18

STATEMENT OF CASH FLOWS

Sr. No	Course Outline Topics
1	Purpose of Preparing Statement of Cash Flows
2	Format of Statement of Cash Flows
3	Cash generated from Operations
4	Working Notes
5	Practice - Preparing Cash Flow from Receipt and Payment Account
6	Practice - Preparing Cash Flow from Balance Sheet of Two Years

Topic videos 164-169 are mandatory part of this module

Purpose of preparing Statement of Cash Flows

Statement of Cash Flows is an analytical statement that is prepared to analyze all cash receipts and cash payments during an accounting period.

Cash Receipts → Cash In-flows

Cash Payments → Cash Out-flows

<u>Difference between Cash Book, Receipt & Payment Account, and Statement of Cash Flows</u>

Question arises; each business entity prepares cash book and few organizations prepare receipts and payments account then why do we prepare statement of cash flows?

As a matter of fact, these accounting records/reports carry different characteristics and perform different functions. In certain cases, an organization would be preparing all of these three records/reports.

Cash Book → is maintained chronologically for all receipts and payments. It is a book of original entries to record cash transactions only. In the presence of cash book, cash account and bank account are not maintained in general ledger therefore cash book is also considered as a book of secondary entry.

Receipt & Payment Account → is a report that is prepared at the end of a reporting period. It is maintained for small entities particularly the non-profit organizations, which do not follow accrual basis of reporting.

Statement of Cash Flows → is an analysis of all receipts and payments that occurred during the reporting period. It is analyzed into three activities i.e., Operating Activity, Investing Activity, Financing Activity. It is prepared for a specific reporting period and becomes integral component of financial statements as per IAS 1.

Format of Statement of Cash Flows

Company Name
Statement of Cash Flows
For the year ended, 30th June 20X9

Operating Activity:	**Rs.**	**Rs.**
Cash generated from operations **(W-1)**	***	
Cash received from Interest/Dividends **(W-2)**	***	
Cash paid for interest/financial charges **(W-3)**	(**)	
Cash paid for Income Tax **(W-4)**	(**)	***
Investing Activity:		
Cash paid for purchasing non-current assets **(W-5)**	(**)	
Cash received from disposal of non-current assets **(W-5)**	***	***
Financing Activity:		
Cash received from owners as Capital	***	
Cash paid to owners as Drawings / Dividend	(**)	
Cash received as loan (short and long-term / loan certificates	***	
Cash paid for repayment of loan (short-term and long-term)	(**)	
Cash paid for redemption of loan certificates	(**)	***
Net cash In-flow / Out-flow during the year		***
+ Opening Cash and Cash Equivalents **(W-6)**		***
Closing Cash and Cash Equivalents **(W-6)**		***

Workings:

W-1 (Direct Method)

Cash generated from operations:

Cash collected from Customers (W-a)	***
Cash paid to suppliers (W-b)	(**)
Cash paid to and on behalf of employees	(**)
Cash paid for other operating Expenses (W-c)	(**)
	***

W-1(a)

Customers' (Debtors) A/c.

	Rs.		Rs.
Opening Debtors	**	**Cash from customers**	?
Total Sales (Cash+ Credit)	**	Bad Debts	**
		Discount Allowed	**
		Closing Debtors	**
	**		**

W-1(b)

Suppliers' (Creditors) A/c.

	Rs.		Rs.
Cash Paid to suppliers	?	Opening Creditors	**
Discount Received	**	Total Purchases w-1(b-i)	**
Closing Creditors	**		
	**		**

W-1(b-i)

Total Purchases			**Rs.**
Cost of Goods Sold		***	
+ Closing Stock	***		
- Opening Stock	***		
Total Purchases	***		

W-1(c)

All operating Expenses	***		
Less:			
Salaries & Wages		**	
Depreciation		**	
Amortization		**	
Loss on Disposal of Asset		**	
Bad Debts		**	
Discount Allowed		**	(**)
Cash paid for Operating Expenses	***		
+Opening Due	***		
-Closing Due	(**)		
-Opening Advance	(**)		
+Closing Advance	***		
Cash paid for Operating Expenses			***

<u>W-1</u> <u>(Indirect Method)</u>

<u>Cash Generated from Operations:</u>

Profit (after tax) ***			
+ Income Tax Expenses			***
Profit before Tax			***
+ Financial Changes (Interest Expenses)			***
Other incomes:			
- Profit on disposal and Interest Income etc.			(**)
Profit from Operations			***
+ Non-Cash Operating Expenses (Non-Current Assets)			
Depreciation/Amortization	***		
Impairment	***		
Loss on disposal	***	***	
± Adjustment for non-cash working capital items:			
Stock		***	
Debtors		***	
Prepaid Operating Expenses		***	
Creditors		***	
Accrued operating Expenses		***	
Cash Generated from operations			***

Increase -
Decrease +

Increase +
Decrease -

<u>W-2</u>

Interest Income (from I/S)	***
+ Opening Interest Due (Assets in previous B/S)	***
- Closing Interest Due (Assets in current B/S)	(**)
Cash Received for Interest	***

<u>W-3</u>

Interest Expense (from I/S)	***
+ opening interest Due (Liabilities in Previous B/S)	***
- Closing interest Due (Liabilities in Current B/S)	(**)
Cash Paid for Interest	***

<u>W-4</u>

Income Tax Expense (from I/S)	***
+ Opening Tax Provision (Liabilities in Previous B/S)	***
- Closing Tax Provision (Liabilities in Current B/S)	(**)
Cash Paid for Income Tax	***

W-5

Fixed Asset (cost) A/c.

Opening Balance	**	Disposal	**
New Purchases	**	Closing Balance	**
	**		**

Provision for Depreciation A/c.

Disposal	**	Opening Balance	**
Closing Balance	**	Depreciation F.T.Y.	**
	**		**

Asset Disposal A/c.

Fixed Asset Cost	**	Provision for Dep.	**
Profit/Gain	**	**Cash (Sales proceed)**	**
	**	**Loss**	**

W-6

Cash and Cash Equivalents

	Opening Balance	**Closing Balance**
Cash in hand	**	**
Cash at Bank	**	**
Very short-term Investments	**	**
Bank Overdraft	(**)	(**)
Cash and Cash Equivalents	**	**

Practice 18.1

Cash Receipt and Payment Account
For the year ended December 31, 20X9

Receipt	Rs.	Payments	Rs.
Opening Balance	5,650	Purchase of Machinery	146,750
Interest on Investment	800	Drawing	8,000
Loan from Babar	100,000	Interest on loan	500
Fresh Capital	74,000	Income tax paid	3,000
Cash from Debtors	60,000	Salaries	5,000
Sales	5,000	Wages	3,000
Bad Debts Recovered	1,350	Electricity Bill	1,000
Sale of Machine	9,200	Rent	500
		Creditors paid	25,000
		Purchases	8,000
		Loan repaid	50,000
		Closing Balance	5,250
Total	**256,000**	**Total**	**256,000**

Prepare Statement of Cash Flows for the year ended December 31, 20X9

Business Name

Statement of Cash Flows
For the year ended 31.12.2008

	Rs.	*Rs.*
Operating Activity		
Cash received from customers		
Debtors	60,000	
Sales	5,000	
Bad debts received	1,350	66,350
Cash paid to suppliers		
Creditors	25,000	
Purchases	8,000	(33,000)
Cash paid to employees		
Salaries	5,000	
Wages	3,000	(8,000)
Cash payment for other operating expenses		
Electricity	1,000	
Rent	500	(1,500)
Cash generated from operations		**23,850**
Interest and dividend received	800	
Interest on loan paid	(500)	
Income tax paid	(3,000)	**21,150**
Investing Activity		
Sales of machine	9,200	
Purchase of machine	(146,750)	**(137,550)**
Financing Activity		
Fresh capital	74,000	
Drawings	(8,000)	
Loan taken from B	100,000	
Loan repaid	(50,000)	**116,000**
Net cash out flow during the year		(400)
Opening cash and cash equivalent		5,650
Closing cash and cash equivalent		5,250

Practice 18.2

Balance Sheet	**20X9**	**20X8**
	Rs.	**Rs.**
Fixed Assets		
Cost	25,000	15,000
Provision for depreciation	(5,000)	(2,000)
Net Book Value – Fixed Assets	20,000	13,000
5% Investments	10,000	0
Current Assets		
Stocks	3,000	3,500
Debtors	1,200	1,000
Prepaid expenses	200	300
Bank and Cash balances	4,000	2,000
	38,400	**19,800**
Owners' Equity	30,000	18,000
Liabilities		
8% Bank loan	7,000	0
Creditors	1,000	1,500
Accrued Expenses	400	300
	38,400	**19,800**

Other Information	**Rs.**
Drawings During the year	8,000
Fresh Capital Introduced	15,000

Machine cost Rs.6,000 NBV Rs.4,800 sold for a loss of Rs.1,200

Prepare statement of cash flows for the year ending 31-12-20X9

Statement of Cash Flows
For the year ended 31. 12. 2009

	Rs.	Rs.	Rs.
Operating activity			
Net profit (W-4)		5,000	
Financial charges (Interest on loan)		560	
Other income (Interest on investment)		(500)	
Profit from operations		5,060	
Add back			
Non-cash operating expense (non-current asset)			
Depreciation (W-2)	4,200		
Loss on disposal	1,200	5,400	
Adjustments for working capital items			
Debtors increased by	(200)		
Stock decreased by	500		
Prepaid expenses decreased by	100		
Creditors decreased by	(500)		
Accrued expense increased by	100	0	
Cash generated from operations		10,460	
Interest received		500	
Interest paid		(560)	10,400
Investing Activity			
Sale proceeds of machine (W-3)		3,600	
Fixed asset purchased (W-1)		(16,000)	
Investments purchased		(10,000)	(22,400)
Financing Activity			
Fresh capital		15,000	
Drawings		(8,000)	
Loan taken		7,000	14,000
Net cash inflow during the year			2,000
Opening cash and cash equivalent			2,000
Closing cash and cash equivalent			4,000

Workings:

W-1

Fixed Asset A/c.

	Rs.		Rs.
Opening balance b/f	15,000	Disposal	6,000
Additions (Bal. figure)	16,000	Closing balance c/f	25,000
	31,000		31,000

W-2

Accumulated Depreciation A/c.

	Rs.		Rs.
Disposal	1,200	Opening balance b/f	2,000
Closing balance c/f	5,000	Depreciation expense	4,200
	6,200		6,200

W-3

Asset Disposal A/c.

	Rs.		Rs.
Fixed asset	6,000	Acc. depreciation	1,200
		Loss on disposal	1,200
		Cash received (Bal figure)	3,600
	6,000		6,000

W-4 **Net profit**

	Rs.
Closing capital	30,000
Drawings	8,000
Fresh capital	(15,000)
Opening capital	(18,000)
Net profit	5,000

<u>Important Tips To Remember (ITTR)</u>

Name of the Organization
Income Statement
For the year ended December 31 20X9

- Sales
  - Cash Sales
  - Credit Sales
- Cost of Goods Sold
  - Opening Stock
  - Purchases
    - Cash Purchases
    - Credit Purchases
  - Closing Stock
- Gross Profit
- Operating Expenses
- Cash based expenses
  - To be adjusted with:
    - Accrued Expenses
    - Prepaid Expenses
- Expenses against receivables
    - Bad Debts/Discounts
    - Provision for doubtful debts
- Expenses against fixed assets
    - Depreciation/Amortization
    - Loss on disposal
- Profit from operations
- Other Incomes
- Cash based income
  - To be adjusted with:
    - Accrued incomes
    - Unearned incomes
- Incomes against payables
    - Discounts
- Incomes against fixed assets
    - Gain on disposal

All cash flows relating to operating activity originate from Income Statement

Net profit

Name of the Organization
Statement of Financial Position (Balance Sheet)
As on December 31 2009

Assets
- Fixed Assets
  - Addition
  - Disposal
  - Depreciation
- Investments
  - Addition
  - Disposal
- Current Assets
  - Stocks
  - Debtors
  - Prepaid expenses
  - Accrue incomes
  - Bank
  - Cash

All cash flows relating to investing activity originate from Non-Current Assets

Owner's Equity
- Opening balance
- Fresh capital
- Net profit
- Drawings

Liabilities:
- Loans
  - Further loan taken
  - Repayment of loan
- Current liabilities
  - Creditors
  - Accrued expenses
  - Unearned incomes
  - Bank overdraft

All cash flows relating to financing activity originate from Owners' Equity and Non-Current Liabilities

MCQs

1. A draft statement of cash flows contains the following:

	Rs.m
Profit before tax	22
Depreciation	8
Increase in inventories	(4)
Decrease in receivables	(3)
Increase in payables	(2)
Net cash inflow from operating activities	21

Which of the following corrections needs to be made to the calculations?

1. Depreciation should be deducted, not added.
2. Increase in inventories should be added, not deducted.
3. Decrease in receivables should be added, not deducted.
4. Increase in payables should be added, not deducted.

A. 1 and 2
B. 1 and 3
C. 2 and 4
D. **3 and 4**

2. The figures below have been prepared for inclusion in the statement of cash flows of Bamboo.

	Rs.
Tax and dividends paid	87,566
Increase in payables	13,899
Decrease in inventory	8,900
Redemption of loans	300,000
Increase in receivables	6,555
Reduction in cash and cash equivalents	3,211
Depreciation charge	10,600
Payments to acquire non-current assets	47,999
Proceeds from sale of non-current assets	13,100

What is the cash generated from operations?

A. $331,688
B. $338,110
C. $425,676
D. **$419,254**

Explanation	**Rs.**	**Rs.**
Cash generated from operation (Balancing figure)	**419,254**	
Tax and dividends paid	-87,566	
Cash flow from operating activity		331,688
Payments to acquire non-current assets	-47,999	
Proceeds from sale of non-current assets	13,100	
Cash flow from investing activity		-34,899
Redemption of loans	-300,000	
Cash flow from financing activity		-300,000
Reduction in Cash and Cash Equivalents		-3,211

3. A business had fixed assets with a book value of Rs.50,000 at the end of the previous year. At the beginning of the current year the business sold an asset for Rs. 5,000 that had cost Rs.4,000 and had yet been depreciated by Rs.1,500. Depreciation charge for the current year was Rs.9,000. The book value of assets at the end of the financial year was Rs.46,000.

How much cash has been invested in non-current assets during the year?

A. Rs.4,000

B. **Rs.7,500**

C. $9,000

D. $10,000

8. The draft accounts of GoGo business for the year ended 31 July 20X9 show a profit of Rs.54,250 prior to the correction of the following errors:

1. Cash drawings of Rs.250 have not been accounted for.
2. Bad debts of Rs.420 were not accounted for in the journal.
3. Rental received Rs.300 has been classified as Interest income.
4. A cheque of Rs.200 was received from a customer, but no bookkeeping entries have yet been made.

What is the correct profit of the business for the year?

A. Rs.53,580
B. **Rs.53,830**
C. Rs.54,250
D. Rs.55,830

(54,250 – 420 unrecorded bad debts) all other rectifications do not affect business profit.

9. Danish gives a cash discount of Rs.40 to a customer. The discount is credited to the discounts allowed account.

The effect of recording the discount in this way is that profit will be:

A. correct
B. **overstated by Rs.80**
C. understated by Rs.80
D. understated by Rs.40

(Discount allowed that is an expense has been given credit effect hence understating profit with double amount)

10. The book-keeper of High-Hopes was instructed to make a contra entry for Rs.270 between the supplier account and the customer account for Grey-Ground. He recorded the transaction by debiting the customer account and crediting the supplier account with RS.270. The business accounts do not include control accounts.

Which of the following statements is correct?

A. Unless the error is corrected, profit will be over-stated by Rs.540
B. Unless the error is corrected, net assets will be over-stated by Rs.270
C. Unless the error is corrected, net assets will be over-stated by Rs.540
D. **The errors should be corrected, but neither the profit nor the net assets are over-stated**

(Income or expense head is not involved. Net effect on assets and liabilities is NIL)