- To separate small payments from the main cash book
- Reducing the workload of the main cashier.

Ans to Q5: Contra entry is such an entry in a cash book which represents the reversal or cancellation of an entry on the other side. The debit and credit aspects of a transaction are recorded in the same account but in different columns, a contra entry takes place.

Ans to Q6: Journal proper is one of the important subsidiary books. It is a subsidiary book in which not all but only a few types of transactions are recorded.



5.15 MODEL QUESTIONS

1. What are subsidiary books? Why are they prepared?
2. What is the difference between trade discount and cash discount?
3. What does the discount column in a triple column cash book mean?
4. What is a contra entry?
5. What is a petty cash book?

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UNIT 6: TRIAL BALANCE

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Concept of Trial Balance

6.4 Format of Preparing Trial Balance

6.5 Objectives of Preparing a Trial Balance

6.6 Methods of Preparing a Trial Balance

6.7 Nature of Ledger Account Balances

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6.10 Errors Disclosed and Not Disclosed by a Trial Balance

6.11 Steps to Locate the Errors

6.12 Let Us Sum Up

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6.14 Answers to check your progress

6.15 Model Questions

6.1 LEARNING OBJECTIVES

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

- discuss the meaning of Trial Balance
- outline the preparation of Trial Balance
- explain the format of trial balance
- discuss the how errors are rectified

6.2 INTRODUCTION

You are aware that whenever a transaction takes place, it is first recorded in journal, and then it is posted in ledger. After that all ledger accounts are balanced.

In this unit, we will discuss trial balance, which is prepared after balancing all the ledger accounts. Trial balance is a statement which is

prepared with the ledger balances. Trial balance helps in detecting the errors which may have been committed in recording or posting the transactions. At the same time, it facilitates the preparation of final accounts at the end of the accounting period.

This unit will help you in gaining knowledge about the preparation of trial balance and the importance of preparing it. At the same time you will come to know certain limitation of trial balance.

6.3 CONCEPT OF TRIAL BALANCE

Any business will be interested to know the net result i.e. profit earned or loss suffered after a certain period of time. The business will also be interested to know the position of its assets and liabilities after a certain period of doing business. In order to find the profit or loss or to know the financial position of the business, it is necessary that the business prepare its final accounts. Again, before preparing the final accounts, it is also necessary to ensure that the books of accounts that are maintained do not contain any error. For this a statement is prepared to check the arithmetical accuracy of the books of accounts. This statement is called a Trial Balance.

Let us go through some of the definitions of trial balance-

Cropper defined trial balance as, “A Trial Balance is a classified list of the balances appearing, at any given date, in the Ledger or Ledgers before the closing entries have been made.”

Thus, the trial balance is a statement which contains the ledge balances. It is prepared at the end of an accounting period. It ensures that no journal entry is left without posting it to the respective ledger and no ledger remains unbalanced. The book- keeper assures that journal and ledger books are arithmetically correct.

The Trial Balance is a statement of accounts, the main purpose of which is to prove that the books of accounts are arithmetically accurate. It is a statement prepared on a certain date and on the basis of debit and credit balances of ledger accounts to verify the arithmetical accuracy of the books. The total of the debit and credit side of the trial balance must be equal. If the two sides are not equal, than we can assume that a mistake

has been committed at some place while preparing the books of accounts. But, sometimes even if the debit and credit total are equal, still there can be mistake. We will discuss about these in the later part of the chapter.



LET US KNOW

In the double entry system of book- keeping, at least two accounts are involved in a transaction. In other words, for every debit entry or for every series of debit entries there is a credit entry or a series of credit entries with equal amounts. From the journal, each and very debit account and credit account is posted to the respective ledger accounts with the same amount as entered in the journal. After balancing the accounts in the ledger book, when all closing balances are placed in trial balance, then debit side and the credit side of the trial balance becomes equal. If debit side and the credit side of the trial balance become equal, it implies that journalising and ledger posting are arithmetically correct.

6.4 FORMAT OF PREPARING A TRIAL BALANCE

A trial balance is usually prepared in the following format-

Trial Balance of M/S..... as at.....

Particulars	L.F. (Rs.)	Debit Amount (Rs.)	Credit Amount (Rs.)
Account Head 1	—	—	—
Account Head 2	—	—	—
Account Head 3	—	—	—
Account Head 4	—	—	—
Account Head 5	—	—	—
Total		—	—

Particulars column: In the 'particulars' column, the names of the account heads are written.

L.F. column: In the 'ledger folio' column, the page numbers are written from where the information of a particular ledger is taken.

Debit Amount column: In this column, the debit amount of the particular ledger is written.

Credit amount column: In this column, the credit amount of the particular ledger is written.

6.5 OBJECTIVES OF PREPARING A TRIAL BALANCE

The main objectives of preparing trial balance may be discussed as under-

a) **To test arithmetical accuracy:** The trial balance is prepared to test the arithmetical accuracy of the transactions entered in journal and posted in the ledger.

b) **To ensure recording of two aspects:** Preparation of trial balance ensures the fulfilment of the principles of double entry system while recording transactions i.e. both the aspects of the transactions (debit and credit) are recorded and posted.

c) **To detect errors:** Trial balance helps in detecting and locating some of the errors that may have been committed in journalising the transactions and while posting them into ledger or balancing the ledgers or while preparing the trial balances itself.

d) **To summarise the financial transactions:** Trial balance helps in summarising the business transactions. As the business transactions are recorded in the journal book date- wise and these are posted into the ledger periodically, transactions in the summarised form is available only in trial balance.

e) **To facilitate preparation of final accounts:** Final accounts help in ascertaining the financial position of a business concern. Trial balance facilitates the preparation of final accounts.



CHECK YOUR PROGRESS

Q1: What is trial balance?

.....

.....

.....

Q2: State any four objectives of trial balance.

.....

.....

.....

6.6 METHODS OF PREPARING A TRIAL BALANCE

The trial balance is an important statement that is prepared in order to prepare the final accounts. Trial balance contains balances of all ledger accounts, which may be related to incomes, expenses, assets, liabilities and capital of the business. The trial balance is generally prepared at the end of the accounting period. However, an organisation may prepare its trial balance monthly, quarterly, half yearly.

There are two different methods to prepare trial balance which we will discuss in this section. Let us first go through the steps of preparing the trial balance.

The preparation of trial balance involves the following steps-

- All the ledger accounts are closed at the end of an accounting period. The ledgers will show either debit or credit balance ;
- The ledgers which show debit balances will be put on the debit side of the trial balance with the respective amounts. On the other hand, the ledgers which show credit balances will be put on the credit side of the trial balance with the respective amounts;
- The debit amount column and the credit amount column of the trial balance will be calculated;
- If both the columns show the same results, the trial balance is complete.

To recapitulate it, the journal entries are posted from the journal book in the respective ledgers maintained in the ledger book. The accounts which have been debited in journal will be posted on the debit side of that particular ledger and the account which have been credited in the journal will be recorded in 'Particulars' column as- "To .....(Name of the Account Credited). For example, for the transaction- Goods purchased for Rs. 5000 from XY Co. on credit, will be recorded in journal as –

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Purchase A/c Dr. To XY Co. (Being goods purchased on credit)	5,000		5,000

The journal entry will be posted in the respective ledgers of Purchase and XY Co. and will be balanced as under-

Dr. Purchase Account Cr.

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
	To XY Co.		5, 000		By Balance c/d		5, 000
			5, 000				5, 000
	To Balance b/d		5, 000				

Dr. XY Co. Cr.

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
	To Balance c/d		5, 000		By Purchase A/c		5, 000
			5, 000				5, 000
					By Balance b/d		5, 000

In the above example, Purchase account is showing debit balance whereas the account of XY Co. is showing credit balance. Therefore, in the trial balance, purchase account will be placed on the debit side and the account of XY Co. will be placed on the credit side. In this case, both the debit and credit amount columns will show the same result indicating that the trial balance is agreed. This procedure is followed for all the accounts. The trial balance will be look as under-

Trial Balance of ..... as on .....

Account Heads	L.F.	Debit (Rs.)	Credit (Rs.)
Purchase	-	5, 000	
XY Co.	-		5, 000
-	-		
-	-		
-	-		
-	-		
Total		5, 000	5, 000

Let us move to the next important topic i.e. the different methods of preparing trial balance.

In general, trial balance can be prepared in any of the following methods-

1. Total or Gross Trial Balance;
2. Net or Balance Trial Balance.

Now we will discuss these three methods -

1. **Total or Gross Trial Balance:** In this method, the totals of the debit side and the credit side of each ledger account are entered in the debit column and credit column respectively of the trial balance. If an account has equal debit and credit i.e. the account has neither debit balance nor credit balance, such accounts may or may not be included in this method. This method is not generally followed in practice.

Under this method, the steps followed for the preparation of trial balance are stated below-

- The amount columns of each ledger and the cash book is totalled up;

- A list is prepared by placing the names of the ledgers along with two amount columns - one for debit amounts and the other for the credit amounts;
- The debit total and the credit total of each ledger is put in the debit amount column and the credit amount column against the names of the accounts in the list;
- The amount columns are added up separately to ascertain whether the columns agree or not.

Example 6.1: Trial balance as on 31-12-2017

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

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

2. **Net or Balance Trial Balance:** This method of preparing a trial balance is most common in practice. In this method, the balances of the ledger accounts are found and the accounts having debit balances are entered in the debit side of the trial balance with the amount of the balance and the accounts having credit balances are entered in the credit side. An account where the total of the debits is more than the total of the credits, is called an account having debit balance. On the other hand an account

where the total of the credits exceed the total of the debits, the account is said to be having credit balance.

Under this method, the steps followed for the preparation of trial balance are as under-

- Each ledger account and the cash book is balanced at the end of a certain period;
- A list is prepared by inserting the names of the ledgers with two amount columns - one for debit amounts and the other for the credit amounts;
- The amounts of the ledgers which have shown debit balances are put in the debit column of the list;
- The amounts of the ledgers which have shown credit balances are put in the credit column of the list;
- The debit and the credit amount columns are added up to see whether the two columns show the same result.

This method is generally followed in the preparation of trial balance. In this unit we will follow this method.

6.7 NATURE OF LEDGER ACCOUNT BALANCES

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

1. Asset Account: Asset Accounts shows debit balances. Therefore the following accounts being assets Accounts will show debit balances:

Goodwill Account

Land and Building Account

Machinery Account

Furniture Account

Patent Account

TradeMark Account

Live stock Account

Vehicles Account

Cash (in hand) Account

Bank (Cash at bank) Account

Loans and advances (granted to others) Account

Prepaid Expenses Account

Accrued Interest Account

Stock of Stationery (in hand) Account

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

Sundry Creditors Account

Bills Payable Account

Loans and Advances Taken Account

Debenture Account

Outstanding Expenses Account

Income Received in Advance and

Interest Payable Outstanding

3. Revenue Accounts Show Credit Balances.

Sales Account

Interest Received Account

Rent Received Account

Dividend Received Account

Royalties Received Accounts

Profit from Branches

Profit on Consignment

Sundry / Miscellaneous Receipts Account

Subsidies Account

Discount Received Account

Bad Debts Recovered Account

Interest on drawings Account

4. Expenses and Losses show Debit balance:

Purchase Account

Carriage Inward Account

Wages Account

Salaries Account

Insurance Premium Account

Commission Account

Rent (Paid) Account

Traveling Expenses Account

Printing and Stationery Accounts

Bad Debts Accounts

Depreciation Account

Fire Loss Account (not covered by insurance)

Sundry Expenses

Interest on Capital

Capital Account shows a Credit balance

Drawings Account show Debit balances

Reserve and fund Accounts show Credit balance

5. Miscellaneous Accounts

Returns Inward shows a Debit balance

Returns Outward shows a Credit balance

Preliminary Expenses show Debit balance

Deferred Expenses show Debit balances



Exercise 6.1

Prepare Trial Balance from the following items of ledger balances as on 31st December. 2017

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

Solution :

Particulars	**L.F.**	**Debit Rs.**	**Credit Rs.**
Capital Account		-	20,000
Furniture		10,000	-
Prepaid insurance		500	-
Purchases		5,000	
Sales		-	80,000
Unpaid Salaries		-	15,000
Interest on Investment accrued		2,000	-
10% Investments		20,000	-
Commission received		-	2,000

Carriage	1,000	-
Printing and stationery	3,000	-
Salaries and wages	9,000	-
Cash in hand and at Bank	7,000	-
Depreciation	1,000	
	1,03,500	1,03,500

Let us consider the following transactions (for which we passed journal entries in unit-3) and prepare a trial balance:



Exercise 6.2

Pass journal entries, post them into ledger accounts, balance the ledger accounts and prepare a Trial Balance as on April, 30, 2016 from the following transactions:

2016	
April 1	Rajiv started business with Rs. 10,00,000 in cash in the name of Rajiv Trading Concern.
April 2	Opened a bank account with Rs. 9,00,000.
April 5	Purchased furniture worth Rs. 20,000 and paid through cheque.
April 6	Bought goods in cash Rs. 50,000 and on credit from Shyam Rs. 5,00,000.
April 10	Sold goods in cash Rs. 2,00,000
April 14	Sold goods to Mukesh worth Rs. 4,00,000.
April 20	Purchased goods for Rs. 6,00,000 and paid through cheque
April 25	Paid wages in cash Rs. 500
April 26	Sold goods Rs. 8,00,000 and payment received through cheque
April 30	Paid salary Rs. 5,000 and rent Rs. 8,000 in cash.

Solution:

In the books of Rajiv Trading Concern

Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
2016 01/04	Cash A/c Dr. To Capital A/c (Being starting of business by Rajiv with cash)		10,00,000	10,00,000
02/04	Bank A/c Dr. To Cash A/c (Being bank account opened with cash)		9,00,000	9,00,000
05/04	Furniture A/c Dr. To Bank A/c (Being furniture purchased and paid through cheque)		20,000	20,000
06/04	Purchase A/c Dr. To Cash A/c To Shyam A/c (Being goods purchased in cash and from Shyam on credit)		5,50,000	50,000 5,00,000
10/04	Cash A/c Dr. To Sales A/c (Being cash sales)		2,00,000	2,00,000
14/04	Mukesh A/c Dr. To Sales A/c (Being goods sold to Mukesh)		4,00,000	4,00,000
20/04	Purchase A/c Dr. To BankA/c (Being goods purchased and payment made through cheque)		6,00,000	6,00,000
25/04	Wages A/c Dr. To Cash A/c (Being wages paid)		500	500

26/04	Bank A/c Dr. To Sales A/c (Being goods sold and payment received through cheque)		8,00,000	 8,00,000
30/04	Salary A/c Dr. Rent A/c To Cash A/c (Being salary and wages paid)		5,000 8,000	 13,000

In the books of Rajiv Trading Concern

Ledger Accounts

Dr. Cash Account Cr.

Date	Particulars	J. F.	Amount (Rs.)	Date	Particulars	J. F.	Amount (Rs.)
				2016			
	To Capital A/c		10,00,000	02/04	By Bank A/c		9,00,000
	To Sales A/c		2,00,000	06/04	By Purchases A/c		50,000
				25/04	By Wages A/c		500
				30/04	By Salary A/c		5,000
					By Rent A/c		8,000
				30/04	By Balance c/d		2,36,500
			12,00,000				12,00,000

Dr. Capital Account Cr.

Date	Particulars	J. F.	Amount (Rs.)	Date	Particulars	J. F.	Amount (Rs.)
				2016			
				01/04	By Cash A/c		10,00,000
2016							
30/04	To Balance c/d		10,00,000				
			10,00,000				10,00,000

Dr. Bank Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016				2016			
02/04	To Cash A/c		9,00,000	05/04	By Furniture A/c		20,000
26/04	To Sales A/c		8,00,000	20/04	By Purchases A/c		6,00,000
				30/04	By Balance c/d		10,80,000
			17,00,000				17,00,000

Dr. Furniture Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016				2016			
05/04	To Bank A/c		20,000	30/04	By Balance c/d		20,000
			20,000				20,000

Dr. Purchases Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016							
06/04	To Cash A/c		50,000	2016			
	To Shyam A/c		5,00,000	30/04	By Balance c/d		11,50,000
20/04	To Bank A/c		6,00,000				
			11,50,000				11,50,000

Dr. Shyam Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016 30/04	To Balance c/d		5,00,000	2016 06/04	By Purchases A/c		5,00,000
			5,00,000				5,00,000

Dr. Sales Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
				2016 10/04	By Cash A/c		2,00,000
2016 30/04	To Balance c/d		14,00,000	14/04	By Mukesh A/c		4,00,000
				26/04	By Bank A/c		8,00,000
			14,00,000				14,00,000

Dr. Mukesh Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016 14/04	To Sales A/c		4,00,000	2016 30/04	By Balance c/d		4,00,000
			4,00,000				4,00,000

Dr. Wages Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016 25/04	To Cash A/c		500	2016 30/04	By Balance c/d		500
			500				500

Dr. Salary Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016 30/04	To Cash A/c		5,000	2016 30/04	By Balance c/d		5,000
			5,000				5,000

Dr. Rent Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016				2016			
				30/04	By Balance c/d		8,000
30/04	To Cash A/c		8,000				
			8,000				8,000

In the books of Rajiv Trading Concern

Trial Balance

As on 30th April, 2016

Debit Balances	Amount (Rs.)	Credit Balances	Amount (Rs.)
Cash Account	2,36,500	Capital Account	10,00,000
Bank Account	10,80,000	Shyam Account	5,00,000
Furniture Account	20,000	Sales Account	14,00,000
Purchases Account	11,50,000		
Mukesh Account	4,00,000		
Wages Account	500		
Salary Account	5,000		
Rent Account	8,000		
	29,00,000		29,00,000

6.8 ADJUSTING ENTRIES

Adjusting entries are those journal entries which are recorded at the end of an accounting period to adjust income and expense accounts

so that they comply with the accrual concept of accounting. An adjusting journal entry is typically made just prior to preparing final accounts of a business concern.

The main objectives of adjusting entries is to match incomes and expenses to appropriate accounting periods. The transactions which are recorded using adjusting entries are not spontaneous but are spread over a period of time. Again, all journal entries recorded at the end of the accounting period may not be an adjusting entry. For example, a journal entry for sales on the last day of the accounting period is not an adjusting entry. An adjusting entry always involves either income or expense account.

Types of Adjusting Entries:

- **Adjusting Entries Related to Accruals:** These entries include revenues accrued but, not yet received nor recorded and expenses incurred but, not yet paid nor recorded. For example, interest expense on loan accrued in the current period but not yet paid.
- **Adjusting Entries Related to Prepayments:** Rrevenues received in advance are recorded as liabilities.Expenses paid in advance are recorded as assets. For example, adjustments for unearned revenue, prepaid insurance, prepaid rent, etc.
- **Adjusting Entries Recording Non-cash Items:** These adjusting entries record non-cash items such as
  i. Provision for depreciation
  ii. Provision for bad and doubtful debts
  iii. Inventory at the end
  iv. Interest on Capital
  v. Interest on drawings and so on..

6.9 ERRORS AND THEIR RECTIFICATION

Errors are the mistakes that have been committed while preparing the books of accounts. The errors may be in principle or it may be a numerical error. Again, errors may also be intentional and unintentional errors. Intentional errors are those errors which are committed with a purpose.

But unintentional errors are committed without the knowledge of the person committing those errors.

Types of Errors: There are various types of errors. For example, errors disclosed and not disclosed by the trial balance, one sided and two sided errors. The various types of errors are given below:

1. **Errors of Omission:** Errors of omission are committed at the time of recording the transactions in the journal book or during the posting of entries in ledger. Error of omission may take place in the form of complete omission or partial omission. Let us go through the following example-

   Purchase goods from Ram on credit for Rs. 5, 000. The journal entry fro the transaction is given below-

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Purchase A/c Dr. To Ram (Being goods purchased on credit)		5, 000	 5, 000

   While recording the transaction, if the book- keeper does not record the transaction in the books at all, it is the error of complete omission. This type of error will not affect the trial balance. On the other hand, if the book- keeper records only one aspect of the transaction, say, the Purchase aspect, then it is the error of partial omission.

2. **Errors of Commission:** Error of commission may take place on account of incorrect posting, incorrect additions, wrong balancing of accounts etc. These types of errors affect the trial balance. However, wrong entry in original record and will not affect the trial balance. For example, if a credit sale of goods to Rakesh amounting to Rs. 2, 000 is recorded in the books as Rs. 200 against Purchase account and Rakesh account, it will not affect the trial balance. Similarly, posting to wrong head of account will not affect the trial balance. Let us take the above example. If the book- keeper posted the above transaction to Purchase

account and Rahim account instead of Rakesh Account, then the trial balance will not be able to detect that error. This error will increase the credit balance of Rahim but will trial balance will not be affected. This is because both Rakesh and Rahim are the creditors and their accounts appear on the credit side of the trial balance.

3. **Errors of Principle:** This type of error occurs due to non- compliance of double entry principle in recording the transactions. Errors of principle will affect the financial statements but the trial balance will not be affected. For example, if the rent paid to the landlord is wrongly debited to landlord account instead of rent account, it is an error of principle but there will be no impact on trial balance.
4. **Compensating Errors:** When an error or a series of errors are committed but they are compensated by another error or series of errors, they are called compensating errors. These errors do not affect the trial balance. Let us go through the following example-
   A) Goods sold to Mr. X on credit for Rs. 1, 000
   B) Goods sold to Mr. Y on credit for Rs. 100.

Let us assume that Mr. X account is wrongly debited with Rs. 100 and Mr. Y's account is debited with Rs. 1, 000.

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Mr. X Dr.		100	
	To Sales A/c			100
	(Being goods sold on credit)			
	Mr. Y Dr.		1, 000	
	To Sales A/c			1, 000
	(Being goods sold on credit)			

Thus, under debit of Rs. 900 in X account is compensated by over debit of Rs. 900 in Mr. Y's account. Sales account is credited with a total of Rs. 1, 100. As Mr. X and Mr. Y's account will appear on the debit side and Sales

account will appear on the credit side of the trial balance, therefore, trial balance will agree in spite of the error.

4. **Duplicating Errors:** Duplicating error takes place when a transaction is recorded twice in the journal or posted twice in the ledger. For example, a credit sale of goods amounting to Rs. 500 to Mr. X, if recorded twice or posted twice in the ledgers, will not affect trial balance.

6.10 ERRORS DISCLOSED AND NOT DISCLOSE BY A TRIAL BALANCE

Errors from the view point of Trial Balance are:

- Errors disclosed by a trial balance
- Errors not disclosed by a trial balance

A. Errors Disclosed by a Trial Balance

There are a number of errors which, if committed, will lead to the disagreement of the trial balance. These are:

1. Omission of Posting: The periodical total of a subsidiary books are to be posted in the respective ledger accounts. If the periodical total of any subsidiary book is omitted to be posted, then the trial balance will not agree i.e. two sides of the trial balance will show different total. Similarly, the following errors may also occur:

a) An item may not have been posted from a subsidiary book to ledger account
b) The totals for balances of an account may not have been included in the trial balance
c) The totals of the subsidiary books may not have been posted to the relevant impersonal accounts.

2. Wrong totaling or casting: There may also be wrong totaling of the subsidiary book. Wrong casting means over or under casting than what it should be. The over or under casting of any subsidiary book, the total of which is debited or credited in the ledger will not allow the trial balance to agree. Besides,

a) The total or balance of cash may be incorrect

b) The total of other subsidiary books may be wrong

c) The totals of accounts in ledger and their balances may be wrong

d) The totals of trial balance itself may be wrong.

3. Posting of wrong amount: Sometimes a wrong amount may be posted in the ledger account. Such wrong may be:

a) Incorrect copying of one or more figures

b) Double posting of an entry from a subsidiary book to ledger.

4. Posting on the wrong side: Sometimes the posting from book of primary entry to ledger account may be on wrong side. That is, if instead of debiting an account, it is credited and vice versa, the trial balance would not tally.

Suspense Account

If all the efforts of detecting errors fail and trial balance do not tally, then a new account is opened for such difference amount which is known as Suspense Account. So, a suspense account is an account opened for tallying the trial balance despite the errors remains undetected. The opening of suspense account for making both the sides of the trial balance equal does not mean that the error/s may be forgotten. The amount standing to the debit or credit of the suspense account represents the net effect of one sided errors. After rectification of errors in next accounting period, the suspense account will be automatically closed up.

B. Errors not Disclosed by a Trial Balance

A trial balance cannot be considered as a conclusive proof of the accuracy of the books of accounts. A trial balance is a proof of accuracy of posting but it is not a conclusive or definite proof. There are some errors which do not affect the agreement of the trial balance. The trial balance fails to disclose these errors. These errors are:

a) Errors of Principle

b) Errors of Omission

c) Errors of Commission

d) Compensating Errors

a) Errors of Principle: These errors violate some fundamental principle of accountancy. The errors of principle do not affect the agreement of

trial balance as the amount remains on the correct side though in a wrong account. This means that even if there is an error involving accounting principles, the trial balnce will still agree. An error of principle takes place in the following cases:

i. Treating an expense as an asset
ii. Treating an asset as an expense
iii. Treating an income as a liability
iv. Treating a liability as an income

b) Errors of Omission: This error is committed due to omission in recording a transaction or posting of transaction into ledger account. Such errors are committed erroneously. The entry may be omitted by oversight, loss of vouchers or invoices, non-receipt of invoice, ineffective communication etc.

c) Errors of Commission: This type of errors refers to the errors committed in posting into ledger accounts. It is an error in posting not in the primary entry.

d) Compensating Errors: Compensating errors are also not shown by the trial balance. These errors are those errors which cancel out one another and equal the trial balance to agree. At least two errors are required to be compensating errors. But in actual practice, there may be numerous errors which compensate and neutralize the debit side and credit side errors and the trial balance will tally despite the errors.



CHECK YOUR PROGRESS

Q3: Write the two methods of preparing Trial Balance.

a. ……

b. ……

Q4: What is errors of omission and errors of commission

.....

.....

.....

Q5: What is errors of omission and errors of commission

.....

.....

6.11 STEPS TO LOCATE THE ERRORS

When the trial balance does not agree, efforts to spot the errors and correcting them should be initiated. The following procedures for detecting errors may be adopted:

1. Check carefully the casting of the trial balance.
2. Ascertain the different debit and credit total of the trial balance and divide it by two. Then check whether there is any account head with a balance identical to this quotient. If there is, then see whether this balance has been put in the proper column.
3. See that the balance of all accounts, including cash and bank balances, have been written in the trial balance.
4. See that there is no mistake in the balancing the ledger accounts.
5. Confirm that all postings are made.
6. Re-check the totals of the subsidiary books.
7. See that all the opening balances are brought forward correctly.
8. Scrutinize all postings thoroughly.
9. Open suspense account for the difference amount.

Exercise 6.3



Let us pass rectification journal entries for the following errors:

i. Purchase book was undercast by Rs. 10,000.

ii. Sales book was overcast by Rs. 5,000.

iii. Repairs to machine debited to Machinery account, Rs. 4,000.

iv. Purchase of furniture debited to Purchases account amounting to Rs. 15,000.

v. A sale of Rs. 430 to Ram has been credited to his account as Rs. 340.

vi. Wages paid Rs. 500 wrongly posted in Salary account.

vii. Rent paid Rs. 5,000 wrongly passed through the personal account of the landlord.

Solution:

Rectification Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
i	Purchase A/c Dr. To Suspense A/c (Being undercast in purchase book rectified)		10,000	10,000
ii	Sales A/c Dr. To Suspense A/c (Being overcast in sales book rectified)		5,000	5,000
iii	Repairs A/c Dr. To Machinery A/c (Being repairs of machinery wrongly debited to repairs account, now rectified)		4,000	4,000
iv	Furniture A/c Dr. To Purchases A/c (Being purchase of furniture wrongly debited to purchases account, now rectified)		15,000	15,000
v	Ram A/c Dr. To Suspense A/c (Being sale to Ram amounting to Rs. 430 wrongly credited to his account by Rs. 340, now rectified)		770 770	770

vi	Wages A/c Dr. To Salary A/c (Being wages paid Rs. 500 wrongly posted to Salary account, now rectified)		500	500
vii	Rent A/c Dr. To Landlord's Personal A/c (Being rent paid wrongly passed through the personal account of the landlord, now rectified)		5,000	5,000



6.12 LET US SUM UP

- A trial balance ensures about correct record of debit and credit amounts and the balances obtained from the ledger accounts.
- There are basically two methods of preparing a trial balance:
  a. Total Method, and
  b. Balance Method
- Adjusting entries are those journal entries which are recorded at the end of an accounting period to adjust income and expense accounts so that they comply with the accrual concept of accounting.
- Errors are the mistakes that have been committed while preparing the books of accounts. The errors may be in principle or it may be a numerical error. Again, errors may also be intentional and unintentional errors.
- The opening of suspense account for making both the sides of the trial balance equal does not mean that the error/s may be forgotten. The amount standing to the debit or credit of the suspense account represents the net effect of one sided errors.



6.13 FURTHER READING

1. B. B Dam and H C Gautam, '*Theory and Practice of Financial Accounting*', Capital Publishing Company, Guwahati.
2. Hanif and Mukherjee (2003), '*Financial Accounting*' , Tata McGraw Hill Education.
3. P.C Tulsian (2002) , '*Financial Accounting*', Pearson Education India.



6.14 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q1: A Trial Balance is a classified list of the balances appearing, at any given date, in the Ledger or Ledgers before the closing entries have been made.

Ans to Q2: The four objectives of Trials balance are:

1. To test arithmetical accuracy
2. To summarise the financial transactions:
3. To detect errors:
4. To ensure recording of two aspects

Ans to Q3: Trial balance can be prepared in any of the following methods:

1. Total or Gross Trial Balance;
2. Net or Balance Trial Balance.

Ans to Q4: Errors of Omission is the committed due to omission in recording a transaction or posting of transaction into ledger account. Such errors are committed erroneously. The entry may be omitted by oversight, loss of vouchers or invoices, non-receipt of invoice, ineffective communication etc.

Errors of Commission are a type of errors refers to the errors committed in posting into ledger accounts. It is an error in posting not in the primary entry.

Ans to Q5: If all the efforts of detecting errors fail and trial balance do not tally, then a new account is opened for such difference

amount which is known as Suspense Account. So, a suspense account is an account opened for tallying the trial balance despite the errors remains undetected.



6.15 MODEL QUESTIONS

1. What is a trial balance? How is it prepared?
2. Does a trial balance shows arithmetical accuracy? Explain.
3. What are the objectives of preparing a trial balance?
4. What are errors? What are its types? How are errors rectified?
5. What is a suspense account?

****

UNIT 7: PRESENTATION OF FINAL ACCOUNTS

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Preparation of Final Accounts

7.4 Trading Account

- 7.4.1 Meaning of trading account and gross profit
- 7.4.2 Contents of Trading Account
- 7.4.3 Journal entries relating to preparation of Trading Account.
- 7.4.4 Specimen form of Trading Account

7.5 Profit and Loss account

- 7.5.1 Preparation of profit and loss account
- 7.5.2 Balancing of profit and loss account
- 7.5.3 Distinction between Trading and Profit and Loss A/c
- 7.5.4 Format of Profit and Loss Accounts
- 7.5.5 Provisions & Reserves
- 7.5.6 Provision for Bad and Doubtful Debts
- 7.5.7 Usual Adjustment Entries
- 7.5.8 Closing entries for Preparation of Profit and Loss Account.

7.6 Balance Sheet

- 7.6.1 Meaning of Balance Sheet
- 7.6.2 Steps for Preparation of Balance Sheet
- 7.6.3 Classification of Assets
- 7.6.4 Classification of Liabilities
- 7.6.5 Items appearing in the Balance Sheet
- 7.6.6 Format of Balance Sheet

7.7 Let us Sum Up

7.8 Further Reading

7.9 Answers to Check Your Progress

7.10 Model Questions

7.1 LEARNING OBJECTIVES

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

- prepare final accounts
- learn trading account
- discuss the profit and Loss account
- learn about Balance Sheet

7.2 INTRODUCTION

In this unit we are going to discuss about Final accounts. Final accounts are prepared after the preparation of trial balance. The trial balance contains the balances of all accounts from the ledger(dicussed in unit 6). It includes the accounts of all expenses, incomes, assets, liabilities, capital and drawings. Let us discuss in detail about final accounts in this unit. We will come to know how to prepare a trading account and balance sheet.

7.3 PREPARATION OF FINAL ACCOUNTS

Final accounts are prepared after the preparation of trial balance. The trial balance contains the balances of all accounts from the ledger. The final accounts can be produced more often than once a year in order to give information to the owner(s) on how the business is progressing. However, it is customary to produce annual or final accounts for the benefit of the interested parties.

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

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

(a) Trading Account;

(b) Profit and Loss Account; and

(c) Balance Sheet.

The starting point for preparing final accounts is the trial balance. All the figures recorded on the trial balance are used in the final accounts. The trading account and the profit and loss account are both 'accounts' in terms of double-entry book-keeping. This means that amounts recorded in these accounts must also be recorded elsewhere in the book-keeping system. By contrast, the balance sheet is not an account, but is simply a statement of account balances remaining after the trading and profit and loss accounts have been prepared.

The following points are to be noted while preparing final accounts:

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

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

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

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

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

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

Drawings account, although appears on the debit side of the trial

balance, is shown as a deduction from Capital on the Liabilities side of the Balance sheet.

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

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

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

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

(ix) The total of both sides of the Balance Sheet will always be equal. (Ref. Theory and Practice of Accountancy: B.B. Dam etel).

7.4 TRADING ACCOUNT

7.4.1 Meaning of Trading Account and Gross Profit

Meaning of Trading Account:

Trading account is an account which is prepared for ascertaining the overall result of trading i.e. buying and selling of goods. Ascertainment of overall result of trading is the ascertainment of gross profit earned or gross loss incurred as a result of the trading activities by a business during a particular accounting period.

If the amount of sales exceeds the amount of purchases

and the expenses directly connected with such purchases, the difference is termed as **gross profit**. On the contrary, if the purchases and direct expenses exceed the sales, the difference is called **gross loss**.

All expenses which relate to either purchase of raw material or manufacturing of goods, called 'Direct Expenses', which are recorded in the Trading Account. Thus, trading account is a part of Income Statement.

Meaning of Gross Profit

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

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

Or

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



EXERCISE: 7.1

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

	Rs
Opening Inventory	12,000
Cash Purchases	16,000

Credit Purchases	28,000
Purchase Return	3,000
Cash Sales	39,000
Credit Sales	72,000
Sales Return	4,000
Wages	8,000
Salaries	9,000
Rent	3,000
Other Direct Expenses	14,000
Closing Inventory	5,000

Solution:

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

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

= Rs. 70,000

(ii) **Gross Profit** = Net Sales – Cost of goods sold.

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

= Rs. (1,07,000 – 70,000)

= Rs. 37,000

7.4.2 Contents of Trading Account

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

A. Items shown on the Debit side of the Trading Account:

(1) **Opening Stock (Opening Inventory):** The stock of goods remains unsold at the end of the last year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current

year. This item is shown as the first item on the debit side of the Trading account. It should be kept in mind that there will be no opening stock in case of newly started business. Opening Stock will include the Stock of Raw Materials, Semi-finished goods and finished goods. This item appears on the debit side of the trial balance. Stock of goods is also termed as inventory and, therefore, opening stock is termed as opening inventory.

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

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

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

account include the following.

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

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

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

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

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

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

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

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

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



Levied: Impose and collect

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

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

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

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

For example, a manufacturer of biscuits sell biscuits packed in poly packs. In order to make the biscuits available in saleable condition, this primary packing is necessary. Therefore, they are treated as direct expenses. Now, a person purchases three

packets of such biscuits and the seller packs these three packets for handing over the purchaser, the expenses incurred on such secondary packing is indirect and will be treated as selling expenses and debited to Profit and Loss Account.

B. Items shown on the Credit side of the Trading Account:

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

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

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

(3) Closing Stock (Closing Inventory): The goods remain unsold at the end of the year is known as Closing Stock. It is valued at cost price or market price whichever is less. It includes the Closing Stock of raw material, Closing Stock of semi-

finished goods and Closing Stock of finished goods. Accounting treatment of closing stock will be as under :

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

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

Closing Stock A/c Dr.

To Trading A/c

(Being the incorporation of Closing Stock in the books of account.)

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

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

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

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

c) Valuation and recording of closing stock:

Closing stock should be valued either at cost or market price whichever is lower and should be recorded accordingly. While preparing final account, if the figure of both cost price and market price of the closing stock is given, the closing stock will be shown both in the Trading account and the balance sheet either **at the cost price or market price whichever is lower.** (Ref. Theory and Practice of Accountancy: B.B. Dam etel).

For example, the cost price of stock held by a trader on 31-3-2004 is Rs.12, 000 and will be recorded in the books of account accordingly.

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

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

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

Trading A/c Dr.

To Opening Stock A/c

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

Trading A/c Dr.

To Purchases A/c

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

Purchases Return A/c Dr.

To Purchases A/c or Trading A/c

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

Trading A/c Dr.

To Direct Expenses (Individually) A/c

(5) **For transfer of Sales**

Sales A/c Dr.

To Trading A/c

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

Trading A/c / Sales A/c Dr.

To Returns Inward A/c

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

Closing Stock A/c Dr.

To Trading A/c

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

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

Trading A/c Dr.

To Profit and Loss A/c

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

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

Profit and Loss A/c Dr.

To Trading A/c

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

7.4.4 Specimen Form of Trading Account

In the books of ……..

Trading Account

For the year ended on ……

Dr. Cr.

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



Exercise: 7.2

Following is the extract of the Trial Balance of Ram and Shyam firm as on 31.3.2015.

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

Additional information:

(i) Stock on 31.3.2015 Rs.15,000

(ii) Outstanding wages 500

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

Prepared the Trading Account of the firm for the year ended 31.3.2015

Solution: **In the books of Ram and Shyam**

Trading Account

For the year ended 31st March, 2015

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

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



CHECK YOUR PROGRESS

Q 1: Fill in the Blanks:

a) Final accounts are prepared after the preparation of .....

b) Every adjustments has ..... effects in Final Accounts.

c) All ..... expenses are recorded in trading account.

Q 2: State True or False:

a) Every adjustment in final account has three effects. True/ False

b) Carriage outward is debited to trading account. True/ False

c) Closing Stock is always valued at Market Price. True/ False

d) Gross Profit =Net Sales – Cost of Goods Sold. True/ False

Q 3: What do you mean by Opening stock.

.....

.....

7.5 PROFIT AND LOSS ACCOUNT

Meaning of Profit and Loss Account:

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

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

7.5.1 Preparation of Profit and Loss Account

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

These expenses are incidental to carrying on business; these are called 'Indirect Expenses'. and are broadly grouped under three categories of expenses; viz.

a) Administrative Expenses which include Salaries to Staff, Office Rent, Printing and Stationery etc.

b) Financial Expenses which include Interest on Loan, etc.

c) Selling and Distribution Expenses which include Carriage Outward, Advertisement, etc.

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

Transfer of Net Profit or Net Loss:

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

(a) For Transfer of Net Profit:

Profit and Loss account Dr.

To Capital Account.

(b) For Transfer of Net Loss :

Capital Account Dr.

To Profit and Loss Account.

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

(1) Gross Loss: If trading account discloses Gross Loss, it is

shown as the first item on the debit side of the Profit and Loss Account.

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

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

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

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

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

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

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

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

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

Profit and Loss Account.

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

7.5.2 Balancing of Profit and Loss Account

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

7.5.3 Distinction between Trading Account and Profit and Loss Account

Sl. No.	Basis of Distinction	Trading Account	Profit & Loss Account
1.	Items included	Sales and all the items relating to ascertainment of cost of sales are shown in this account.	All the items of indirect expenditure such as salary, rent, bad debts, discount etc. are shown in this account.
2.	Result	The balance of this Account is named as gross profit/ gross loss.	The balance of this Account is named as net profit/ net loss.
3.	Transfer of balance	The balance of this Account is transferred to Profit and Loss Account.	The balance of this Account is transferred to Capital account.

4.	Utility	Trading Account shows the trend of business activities.	This Account shows the net result of the business. By
5.	Sequence of preparation	By comparing the Trading Account of consecutive periods steps can be taken to increase profitability. It is prepared before the preparation of Profit and Loss Account.	comparing net results of consecutive periods, steps can be taken for an all round development of the business. It is prepared after the preparation of Trading Account.

7.5.4 Format of Profit and Loss Account

Profit and Loss Account

(for the year ending .....)

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Trading A/c		By Trading A/c	
(Gross Loss Transferred)		(Gross Profit transferred)	
Office & Administrative			
Expenses :		By Rent (Cr.)	
To Salaries		By Rent of premises sub-let	
To Salaries & Wages		By Discount received	
To Rent, Rates & Taxes		Or Discount (Cr.)	
To Printing & Stationery		By Commission Received	
To Postage & Telegram		By Interest on Investments	
To Lighting		By Dividend on Shares	
To Insurance Premium (office)		By Sundry Receipts	
To Telephone Charges		By Bad debts Recovered	
To Legal Charges		By Profit on sale of assets	
To Audit Fees		By Income from other Sources	
To Traveling Expenses		By Apprenticeship Premium	
To Establishment Expenses.		By Sale of Scraps	
To Trade Expenses [see note (ii)]		By Royalty Received	
To General Expenses.		By Subsidy from Govt.	
To Royal on sales.		By Interest on Drawings	
To Establishment		By Capital A/c	
To Commission of Office Manager		[Net Loss Transferred to]	

Selling and Distribution Expenses :			
To Carriage Outwards, or Carriage on Sales			
To Advertisement			
To Commission			
To Discount			
To Rebate			
To Brokerage			
To Bad debts			
To Export duty			
To Packing charges			
To Delivery Van Expenses.			
To Wages (Unproductive)			
To Commission to Sales Manager			
Financial Charges :			
To Interest on Loan			
To Bank Charges			
To interest on Overdraft.			
Sundry Expenses :			
To Sales Tax			
To Repairs			
To Depreciation on fixed assets			
To Entertainment Expenses			
To Contingencies			
To Conveyance Expenses			
To Donation and Charity			
To Loss on Sale of Assets			
Provisions :			
To Provision for Doubtful Debts			
To Provision for Discount on Debtors			
To Capital A/c(Net Profit Transferred)			

7.5.5 Provisions & Reserves

Meaning and Characteristics of Provisions:

In course of carrying out business activities, each and every

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

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

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

1 The amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets; or

2 The amount retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

Examples of provisions:

(i) Provision for Income Tax;

(ii) Provision of Sales Tax;

(iii) Provision for liability for disputed claim.

(iv) Provision for depreciation;

(v) Provision for Repairs and Renewals;

(vi) Provision for doubtful debts;

(vii) Provision for discount on debtors;

Characteristics / Features of Provisions:

a) Provision is made to meet a known liability.

b) Although the liability is known, the amount of such liability cannot be determined with reasonably accuracy. For example, it is

almost certain that some of the amount receivable from debtors will become bad but it is not possible to predict the exact amount of such bad debts.

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

d) Provision is created even if there is loss.

Need for creating Provisions:

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

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

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

d) For proper allocation of expenses: Provision is also required to be made for proper allocation of expenses. For example;

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

Nature of balances of Provision and Reserves Accounts:

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

Disclosure in the Balance Sheet:

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

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

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

Accounting Treatment of Provisions:

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

whether the firm earns profit or suffers loss.

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

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

7.5.6 Provision for bad debts and doubtful debts

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

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

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

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

Bad debts A/d Dr.

To Debtors A/c (Individually)

(Being bad debts written off)

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

Bad debts A/c Dr.

To Sundry Debtors A/c

(Being bad debts written off)

Need for creating Provision for Doubtful Debts:

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

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

Provision for Doubtful Debts – How Created:

Since doubtful debts can only be estimated, a provision is

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

Profit and Loss A/c Dr.

To Provision for Doubtful Debts A/c

(Being Provision for Doubtful Debts created on Sundry debtros)



Exercise : 7.3

On 31-12-2017, the Sundry debtors of a firm amounted to Rs.60, 800. Out of debtors Rs. 800 is irrecoverable and the same is to be written off as bad debt.

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

Journal

Date	Particulars	L F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2017	Bad Debts A/c Dr.		800	
Dec.31	To Sundry Debtors			800
	(Being the amount of bad debts written off)			
Dec.31	Profit and Loss Account Dr.		800	
	To Bad Debt Account			800
	(Being the transfer of bad debts to Profit and Loss A/c)			

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

Dr. Profit and Loss Account for the year ended 31-12-2017 Cr.

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

Dr. Balance Sheet as at 31-12-2014 Cr.

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

Creation and Accounting Treatment of Provision for Doubtful Debts:

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

and the same will be shown as deduction from Sundry Debtors in the Balance Sheet.

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

Profit and Loss A/c Dr.

To Provision for Doubtful Debts A/c

(Being Provision for Doubtful Debts created on Sundry Debtors)

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



Exercise: 7.4

Following is the extract of Trial Balance as on 31st December, 2017.

Trial Balance

Sundry debtors	40,000

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

Solution : **Journal**

Date	**Particulars**	**L. F.**	**Dr. Amount (Rs.)**	**Cr. Amount (Rs.)**
2017				
Dec.31	Profit and Loss Account Dr.			2,000
	To Provision for Doubtful Debts A/c			2,000
	(Being the creation of Provision for Doubtful Debts % 5% on Sundry Debtors)			

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

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2017				2017			
Dec. 31	To Balance c/d		2,000	Dec. 31	By Profit and Loss A/c		2,000
				2018			
				Jan.1	By balance b/d		2,000

Profit and Loss Account

For the year ended 31st December, 2017

Dr. **Cr.**

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

Balance Sheet as on 31st December, 2017

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

7.5.7 Usual Adjustment Entries

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

USUAL ADJUSTMENT ENTRIES

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

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

7.5.8 Closing entries for Preparation of Profit & Loss Account

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

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

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

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

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

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

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

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

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

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

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

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

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



Exercise: 7.5

From the following particulars, pass necessary journal entries and prepare a Profit & Loss Account of Mr. K. Baruah for the year ending 31st March, 2017.

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

Donation	1,100	Miscellaneous Receipts	500
Sundry Expenses	360	Advertisement	4,100
Selling Expenses	5,320	Travelling Expenses	2,500

Solution: **In the books of Mr. K. Baruah**

Journal Entries

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2017	Profit and Loss Account Dr.		62,280	
Mar.31	To Trade expenses Account			2,000
	To Carriage on sales Account			10,000
	To Office Salaries Account			15,800
	To Postage & Telegram Account			720
	To Office Rent Account			7,500
	To Legal charges Account			400
	To Audit Fee Account			1,600
	To Donation Account			1,100
	To Sundry expenses Account			360
	To Selling expenses Account			5,320
	To Discount allowed Account			3,000
	To Lighting Account			780
	To Bad Debts Account			1,200
	To Interest on Loan Account			2,200
	To Wages (Unproductive) Account			1,400
	To Export duty Account			2,300
	To Advertisement Account			4,100
	To Travelling expenses Account			2,500
	(Being the transfer of nominal accounts showing debit balances to the Profit & Loss A/c)			
	Commission Received Account Dr.		840	
	Discount Received Account Dr.		600	
	Miscellaneous Receipts Account Dr.		500	

	To Profit & Loss Account (Being the transfer of nominal accounts showing credit balances to the Profit & Loss A/c)			1,940
	Profit and Loss Account Dr. To Capital Account (Being the transfer of net profits to the Capital account)		2,51,660	2,51,660

In the books of Mr. K. Baruah

Profit and Loss Account

For the year ending on 31st March, 2017

Dr. Cr.

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

7.6 BALANCE SHEET

7.6.1 Meaning of Balance Sheet

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

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

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

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

Definition of Balance Sheet:

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

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

7.6.2 Steps for Preparation of Balance Sheet

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

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

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

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

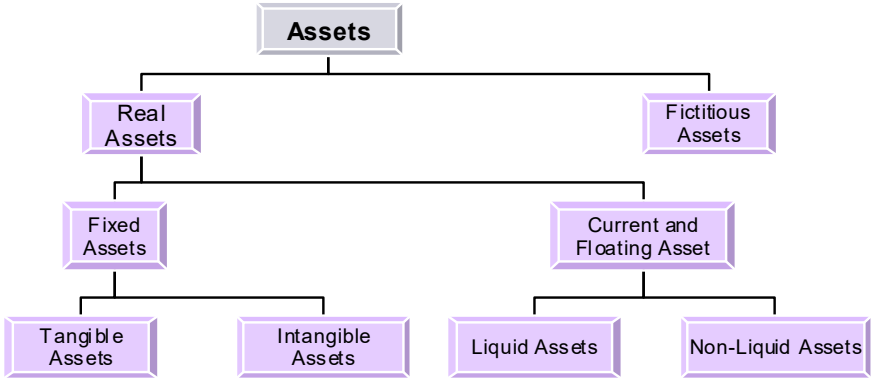
(iv) Drawings account which appears on the debit side of the trial balance will be shown on the liabilities side as a deduction from Capital account.

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

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

7.6.3 Classification of Assets

Assets may be classified as follows:



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

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

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

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

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

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

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

Assets.

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

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

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

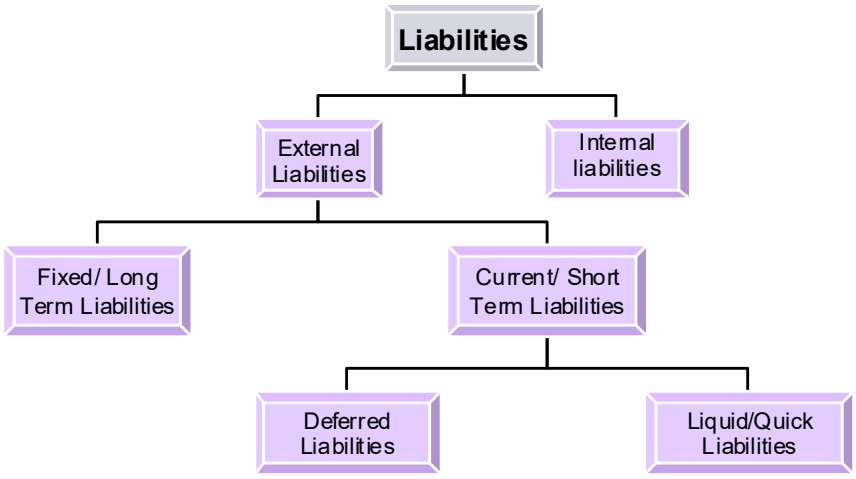
Sundry Debtors and Creditors: Sundry debtors and creditors indicates the total of balances of debtors and creditors at the end of the year. They do not represent any particular ledger account. At the end of each financial period, all the outstanding balances of the debtors and creditors are taken out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

7.6.4 Classification of Liabilities

The term liability denotes claims against the assets of the business by the outsiders and the proprietor. According to the American Accounting Association, Liabilities are "claims of Creditors

against the enterprise arising out of past activities that are to be satisfied by the disbursement or utilization of corporate resources". All liabilities are shown in the liabilities side or left hand side of the Balance Sheet.

Classification of Liabilities



1. **Internal Liabilities:** Internal Liabilities denote proprietor's equity, which consists of capital, reserve and net profit. In case of a net loss, it is deducted from capital.
2. **External Liabilities:** External liabilities are the claims of outsiders against the assets of the business. They are loans taken, creditors, bills payable, bank overdraft, etc. External liabilities are classified into long-term liabilities and short-term liabilities.
   a. **Long-Term Liabilities or Fixed Liabilities:** Long term liabilities are repayable after a long period of time and not repayable in one year. They do not require current assets for repayment Viz. Loan on mortgage, debentures, long term loan from banks or other financial institutions.
   b. **Current Liabilities:** Current liabilities are those liabilities which are usually payable within a year. Generally they are paid out of current assets or by creation of current liabilities. The following are the current liabilities in a business.

(i) Accounts payable or bills payable and trade creditors,

(ii) Liabilities for outstanding expenses,

(iii) Bank overdraft,

i) **Deferred Liabilities:** Deferred liabilities are those liabilities which are repayable in course of less than one year but more than one month.

ii) **Liquid or Quick Liabilities:** Debts which are repayable in course of a month are called liquid or quick liabilities viz. outstanding expenses like salaries, rent, etc.

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

7.6.5 Items appearing in the Balance Sheet

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

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

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

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

'Accrued Interest'.

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

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

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

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

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

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

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

Valuation of Assets:

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

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

In short, fixed assets mush be valued at cost less depreciation while current assets must be valued a cost price or not realizable market price whichever is lower except book debt which should be valued always at realizable value.

7.6.6 Format of Balance Sheet

Forms of Balance Sheet (Under Permanency Order)

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

Liabilities	**Rs.**	**Assets**	**Rs.**
Proprietors' Equity :		**Fixed Assets :**	
Capital		Goodwill	
Reserve/ Reserve Fund		Freehold Land and Building	
Long term Liabilities :		Leasehold Land & Building	
Long term Loans		Buildings	
Current liabilities:		Plant and machinery	
Short term Loans		Furniture and Fittings	
Income Received in Advance		Loose Tools	
Outstanding Expenses		Vehicles	
Sundry Creditors		Patents and patterns	
Bills Payable		Trade Marks	
Bank Overdraft		**Long Term Loans & Advances Current Asset :**	
		Closing Stocks :	

		Raw Materials	
		Work-in-Progress	
		Finished goods	
		Stationery (Stock)	
		Goods on Consignment	
		Prepaid Expenses	
		Accrued Incomes	
		Sundry Debtors	
		Bills Receivable	
		Investment (Short-Terms)	
		Cash at Bank	
		Cash in hand	



Exercise: 7.6

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

Trial Balance as on 31st December, 20…

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

Solution: Ref. Under Liquidity Order:

as on the 31st December. 20…..

Balance Sheet of M/s Goswami Traders

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



CHECK YOUR PROGRESS

Q 4. State True or False:

a) Capital is shown in the Balance Sheet on t h e liabilities side as the excess of assets over liabilities. True/False

b) Balance sheet is an account. True/False

c) Bill Receivable is the total of the bills received from debtors but not yet due for payment. True/False

d) Provisions are made to meet a known liability. True/false

Q 5: Write some examples of Provisions

.....



7.7 LET US SUM UP

- Final accounts are prepared after the preparation of trial balance.
- For most businesses, the final accounts, which are produced at the end of each financial year, comprise:
  - Trading account
  - Profit and loss account
  - Balance sheet
- Trading account is an account which is prepared for ascertaining the overall result of trading i.e. buying and selling of goods.
- The Profit & Loss Account (P&L) is a report of the company's profit on the sale of their goods or the provision of their service over a trading period, normally one year.
- A balance sheet is a statement of the total assets and liabilities of an organization at a particular date - usually the last date of an accounting period.
- In order to measure the result of the business operations with reasonable accuracy, it is required to match revenues of an accounting period with cost in earning the same revenue. If the revenue does not match with cost, the same is accounted for by passing adjusting entries.



7.8 FURTHER READING

1. Ashis Bhattacharya (2006), *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.
2. S. N. Maheshwari (2014), "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.
3. B. B Dam and H C Gautam,"*Theory and Practice of Financial Accounting*",Capital Publishing Company, Guwahati

4. R. L. Gupta and M. Radhaswamy (2017), "*Advance Accountancy*", Sultan Chand & Sons, New Delhi.
5. Jain & Narang (2006),"*Accounting Theory and Management Accounting*",Kalayani Publishers.



7.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) Trail Balance b) Two c) Direct

Ans to Q No 2: a) False b) False c) False d) True

Ans to Q No 3: The stock of goods which remained unsold at the end of the last year is termed as the opening stock of the current year.

Ans to Q No 4: a) True b) False c) True d) True

Ans to Q No 5: Examples of provisions:

a) Provision for Income Tax;
b) Provision of Sales Tax;
c) Provision for liability for disputed claim.
d) Provision for depreciation;
e) Provision for Repairs and Renewals;
f) Provision for doubtful debts;
g) Provision for discount on debtors;



7.10 MODEL QUESTIONS

Q 1: What do you mean by final Account? Explain.

Q 2: Write a note on trading account and also write the items that are shown in the debit side of the trading account. Explain and illustrate with a specimen form of trading account.

Q 3: Explain Profit and loss account with a specimen form.

Q 4: How Profit and loss account is balanced.

Q 5: Distinguish between Trading Account and Profit and loss account.

Q 6: Explain how to prepare a Profit and loss account.

Q 7: What do you mean by Balance Sheet .Explain the steps for preparing Balance Sheet?

Q 8: What the different types of Assets. Explain and classify them.

Q 9: Write Short notes on the following:

a) Gross Profit

b) Opening Stock

c) Provisions and Reserves

d) Provisions for bad and doubtful debts

e) Bills payable and Bills receivable

f) Prepaid Expenses

Q 10: From the following Trial Balance of M/s Ram and Sons; prepared a Trading and Profit and Loss Account for the year ended 31st December….20… and a Balance Sheet as on that date.

Trail Balance of M/s ram and Sons

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

Adjustments:

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

(b) Wages Outstanding Rs.500

(c) Salaries Outstanding Rs.425

(d) Prepaid Insurance Rs.50

11. From the following information of Kalita Printers prepare a Trading Account for the year ended 31st March, 2017.

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

12. From the following information of M/s. Baruah Enterprise prepare a trading Account for the year ended 31st March, 2017

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

13. From the following information of Bulbul Enterprises prepare a Profit & Loss Account for the year ended 31st December, 2016.

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

*** ***** ***

UNIT 8: MANAGEMENT ACCOUNTING

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Meaning of Management Accounting

8.4 The Role of Management Accounting

8.5 Management Accounting Framework

8.6 Functions of Management Accounting

8.7 Tools of Management Accounting

8.8 The Balanced Scorecard

8.9 Merits and Demerits of Management Accounting

8.10 Distinctions between Management Accounting and Financial Accounting

8.11. Cost Management System

8.12. Let Us Sum Up

8.13. Further Reading

8.14. Answer To Check Your Progress

8.15. Model Questions

8.1 LEARNING OBJECTIVES

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

- explain the basic concept of management accounting
- discuss the role and function of management accounting
- describe the tools of management accounting
- explain the basic concepts of The Balanced Scorecard, Cost Management System and Value Added Concept
- outline the difference between Management Accounting and Financial Accounting

8.2 INTRODUCTION

In the first block of the course 'Accounting for Managers' we had discussed the various concepts under financial accounting. In this unit, we

will discuss the concepts related to management accounting. Management accounting has been defined in different ways by a variety of management experts and institutes worldwide. In this unit you will be able to understand the role and functions of Management accounting, Cost Management System, Value Added Concept, Merits and Demerits of Management Accounting and the distinction between Management Accounting and Financial Accounting

8.3 MEANING OF MANAGEMENT ACCOUNTING

Let us try to understand the basic concept of management accounting by some definition given by some important pioneering institutes and experts. A team of British Industrial Accountants and Managers defined Management Accounting:-

"Is the presentation of accounting information in such a way as to assist the management in creation of policy and the day to day operation of an undertaking"

A management expert, Robert N. Antony defined Management Accounting as:-

"Any form of accounting, which enables a business to be conducted more efficiently can be regarded as Management Accounting."

On the other hand, the Institute of Chartered Accountants of England and Wales defined Management Accounting as:-

"Application of professional knowledge and skill in the preparation of accounting information in such a way as to assist management in the formation of policies and in the planning and control of the operations of the undertakings".

Again, the Institute of Cost and Management Accountants, London defined "Management Accounting is the application of appropriate techniques and concepts in processing historical and projected economic data of an entity to assist management in establishing plans for reasonable economic objectives in the making of rational decisions with a view towards these objectives."

The American Accounting Association defined it in a different way as:-

"Management accounting is concerned with accounting information which is useful to management."

Thus we understand from the above definitions that management accounting deals with accounting information, internal reporting and efficiency of the management. It is also concerned with the furnishing of relevant data to management for planning, organising, and controlling which will ultimately help in better decision making. The main objective of management accounting is to use the accounting information for higher efficiency and productivity of the management.

From the above definitions it can be concluded that management accounting provides a system of generating information from all source including cost and financial accounting system for the use by management in formulating policies and strategies , setting of standards, plans, budget or targets and reporting deviations by comparing the planned and actual performance for corrective action so that available resources of the organisation needs of the management for effective planning, decision making and control. To perform these functions efficiently, it uses:

i. Data from different sources like costing, accounting , socio-economic
ii. Various planning and decision making techniques like marginal costing, cost volume profit analysis, break even analysis.etc.
iii. Various control and evaluation techniques like standard costing, budgetary control, statistical control methods, ratio analysis..etc
iv. Internal auditing and management reporting

8.4 THE ROLE OF MANAGEMENT ACCOUNTING

The present business and economic world is well integrated with the world economy and is largely influenced by globalisation. It is dynamic in nature and full of uncertainty. Within this uncertainty, it is the manager who needs to take the right decision based on the available micro and macro information. Management accounting basically deals with all the micro

information that is related to the particular business organisation. Within this unpredictable business world, decision making is ever more challenging and complex which require right information at the right time. Management accounting helps the management of a business organisation by providing all sorts of information that are useful and valuable for the growth and sustainability of the organisation.

The role of the management accounting is to serve the management by preparing different reports which help management to take a number of decisions for different level of management.

Besides the above discussion, management accounting has a big role to assist the management in performance of its functions such as planning, coordinating, communication, control, decision making, financial analysis and interpretation effectively and efficiently.

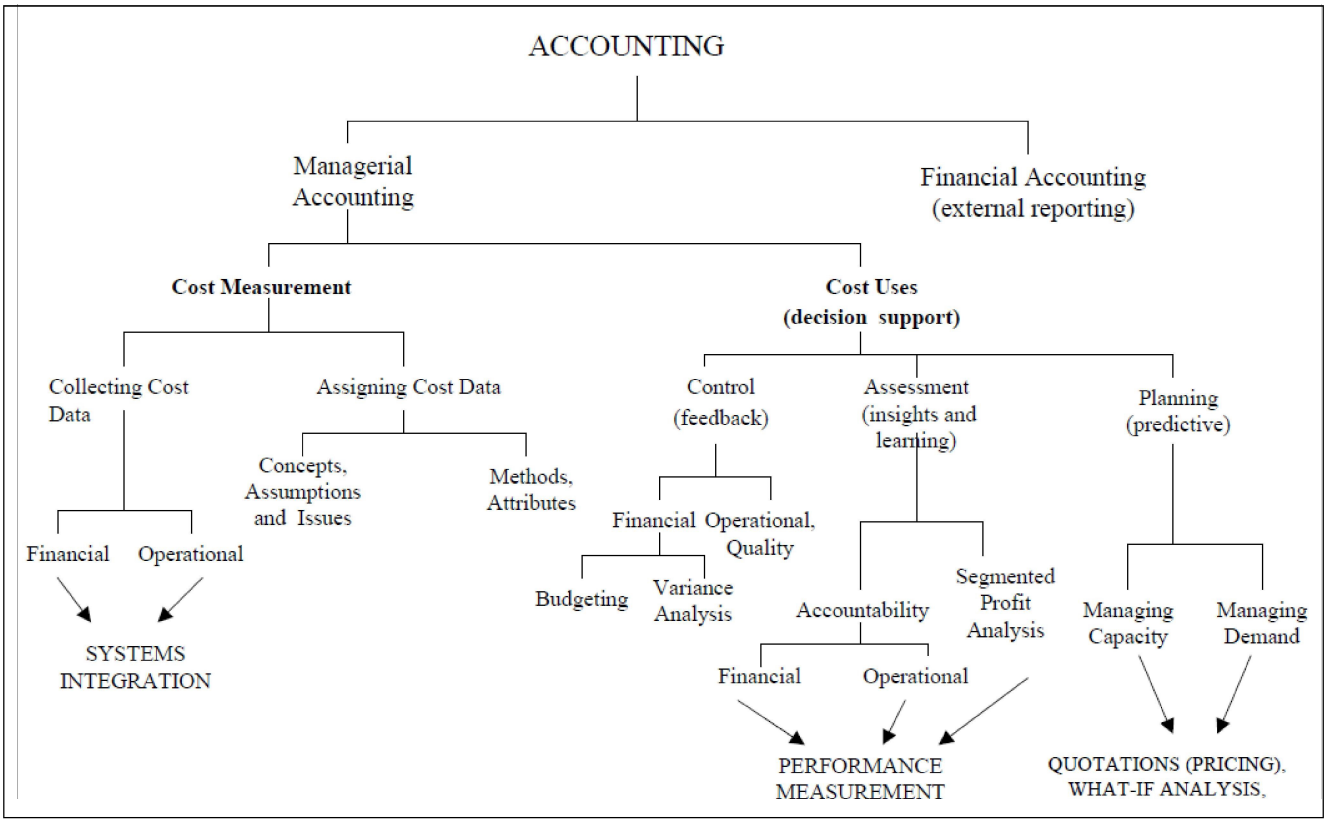
The following are some of the role and objectives of management accounting:

1. **To help management in effective planning and decision making:** management accounting helps in formulation of short and long term plans for the future activities of the business undertaking.
2. **To help management in effective coordination of various functions:** Management accounting helps in achieving effective coordination among the various functional activities like marketing, production, material , budgeting and etc.
3. **To help increasing profitability:** management accounting helps in deciding optimum product-mix and most profitable operations among the different alternatives and discontinuance of loss making operations leading to the maximum profitability of the organisation
4. **Helps in cost reduction:** management accounting helps in reducing and control cost by eliminating wastages, inefficiencies in operating activities.
5. **Evaluation of performance:** by the means of plans, standards, norms or budget management accounting helps in evaluating the performance of various divisions, departments, product line etc.

8.5 MANAGEMENT ACCOUNTING FRAMEWORK

An effective management accounting framework becomes a significant business tool to support economic, social, and environmental aspects of decision-making. This framework assists companies in providing disclosure of performance, while adding value to an organization and ensuring its sustainability. In business, management accounting framework basically deals with data formats, data identification, data accumulation etc. Data accumulation is conducted through financial accounting and cost accounting. Data accumulation is also done from the different levels of the organisational staffs and management which consists of quantitative as well as qualitative in nature. Moreover, data accumulation is also done from external sources. Accumulated data or information is again reclassified as per the requirement of the management personnel to take effective decision.

Fig: 8.1 Management Accounting Framework





CHECK YOUR PROGRESS

Q1: What is "Management Accounting"?

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.....

Q2: Write the role of Management Accounting.

.....

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8.6 FUNCTIONS OF MANAGEMENT ACCOUNTING

Management accounting may also be referred to as management oriented accounting. The main objective of management accounting is to assist management by providing relevant information for taking appropriate decisions and discharge their responsibilities effectively. In order to fulfil this objective, management needs to perform some important functions which may be discussed as follows:-

1. **Provides Crucial Information:** For many instances, the management cannot take a rational decision based on the quantitative data available from the financial accounts, cost accounts or other statement of accounts. All most all the information available from these accounts is quantitative in nature and many times these types of data is not sufficient for the management to take a proper decision. Management accounting provides important relevant quantitative as well as qualitative business information by preparing a suitable form and collect it from the various internal authorities and members of the organisations.
2. **Assists in Planning:** Information provided by the management accountants help the management in organisational planning and forecasting. The management need to prepare both short-term as well as long-term planning. Information provided by the management accountants' help the overall management in preparing short-term as

well as long-term planning. Some of the management accounting techniques used are Budgeting, Standard and Marginal Costing etc.

3. **Facilitates Coordination of Various Activities:** Management accounting acts like a facilitator which brings a proper coordination amongst various related business activities like marketing, finance, operation, systems, logistics, purchases etc. by proving required financial reports.
4. **Brings Control:** Management accounting helps management for achieving greater control over organisational resources by applying various management accounting techniques like internal audit, budgetary control, financial ratios, responsibility accounting, profit centres, cost centres, revenue centres etc.
5. **Provides Qualitative Information:** Besides various quantitative information, management accounting also provides vital qualitative information which helps management to take better decision making. Some of qualitative information are – customer sentiments, employee motivations, legal judgements, quality of the goods and services etc.

8.7 TOOLS OF MANAGEMENT ACCOUNTING

There are many techniques that are considered as a tool of management accounting some of which are briefly mentioned below:-

1. **Net Profit Margin:** If we deduct all the expenses from the overall revenue of an organisation during a particular financial period, we get the net profit margin. Thus we can say that it is the percentage of revenue left after deducting all expenses from the sales figure.
2. **SWOT Analysis:** SWOT analysis helps an organisation to identify its organisational Strength and Weakness. It also find out the opportunities available for the business by scanning the business, social, political, legal and economic environment as well as the threats the business may face in future.
3. **Budgeting:** Budgeting is a process which tries to balance future income and expenditure. In other words, a budget is a statement of estimated income and expenditure that may occur in future. Budgeting ensures