

MGT101 - FINANCIAL ACCOUNTING – I

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Lesson-1**BASIC CONCEPTS OF ACCOUNTING****Learning Objective**

The objective of this lecture is to introduce the subject of “Financial Accounting” to the students and give them an idea as to how did accounting develop?

What is Financial Accounting?

It is the maintenance of daily record of All financial transactions in such a manner that it would help in the preparation of suitable information regarding the financial affairs of a business or an individual.

Why is Financial Accounting needed?

The need for recording financial transactions arises because the individual or business wants to know the performance of the business and to assist the person in making decisions related to the business.

What are Transactions?

In accounting or business terms, any dealing between two persons involving money or a valuable thing is called **transaction**.

Human beings are social animals and are bound to adopt a community living style. Living in a community, essentially means that people interact with other people and are dependant on each other to fulfil their needs. Every person cannot fulfil all his needs like food, clothing, housing etc. on his own. He, therefore, depends on other people for his needs, in return to this providing others with some of theirs. It means that one will fulfil his needs from others and will provide others the things of their need in return. Every instance where one ‘gives something’ to ‘get something’ is called a **transaction**.

How did it develop?

Nearly all developments happen because of human being’s need for the same. Accountancy is no different.

There was times when goods were bartered or exchanged. But when the concept of money was introduced, it became a little more difficult.

What is a Budget?

Budget is a plan of income, expenses & other financial operation for a future period.

Concept of Costing

A person making or producing any thing must not only know how much it costs to make but also to help in determining the selling price. It is necessary that the person not only knows the cost of what is being produced but also the cost of each component which has gone into production. The control of the costs being incurred is also necessary otherwise the same can exceed the estimates. All this is only possible if the costs and data relating to production is properly recorded and analysed. It is an exercise that only carries out by the Accountant.

Impact of IT on Accounting

The old “*Munshi*,” who kept record of the financial dealings was the original accountant. But he is now of no use, as he lacks the capability for analysing the information recorded and forecasting financial information.

In fact, there is no need for any expert in writing of books. Information Technology has taken over. But some one has to tell the Software developer how books are written?

The need for an Accountant who is well versed in the art of writing up books still remains. The role has changed. Information Technology software can now produce the reports and analysis but need the expert to interpret all of this remains.

The need for the professional to describe this has not yet been overtaken by Information Technology.

Barter Trading and Barter Transactions

Trading one commodity or service for another commodity or service is called '**Barter trading**'.

OR

Every transaction where goods are exchanged for goods is called a '**Barter Transaction**'.

Since every person cannot produce every thing that he needs. Therefore, he needs to give / sell what he produces in order to get / buy what he wants?

In early days when 'money' was not introduced, people used to exchange goods for goods. This kind of trade, where goods are exchanged for goods, is called **barter trade**.

In fact, in barter trade, value of one commodity is quoted in terms of other commodity, for example the price of 10 kg of wheat may be equal to 2 meters of cloth or 5 litres of milk. Although, there is no involvement of money but still every commodity has a value, which means that you have to give a specific quantity of one commodity to buy a specific quantity of another commodity.

Money Measurement Concept

With the passage of time, the trading volumes and types of commodities available in the market are increased and it became difficult to exchange commodity with other commodity. That is why the concept of cash / money is introduced and people started valuing all goods / services in terms of a common commodity called money. Now the price of 10 kg wheat would be Rupees 60 instead of 2 meters of cloth. Similarly, the price of 2 meters of cloth and 5 litres of milk would also be Rupees 60.

In accounting, every transaction that is worth recording is recorded in terms of money. In other words any event or item that cannot be translated in terms of money is not recorded in books of accounts.

Cash and Credit Transactions

Translating every transaction in terms of money does not always mean that the money changes hands, the same time at which the transaction takes place. It may be paid before or after the goods are exchanged.

When the money value of an item being purchased is paid, at the same time when the item is exchanged. The transaction is said to be a **cash transaction** or in other words, if the value of transaction is met in cash at the time of the transaction such kind of transaction is said to be cash transaction.

On the other hand, if the payment is delayed to a future date, the transaction is termed as a **credit transaction**.

Different Types of Business Organizations

1. Sole Proprietorship

According to D.W.T. Stafford, "It is the simplest form of business organization, which is owned and controlled by one man"

Sole proprietorship is the oldest form of business organization which is owned and controlled by one person. In this business, one man invests his capital himself. He is all in all in doing his business. He enjoys the whole of the profit. The features of sole proprietorship are:

- Easy Formation
- Unlimited Liability
- Ownership
- Profit
- Management
- Easy Dissolution

2. Partnership

According to Partnership Act, 1932, “Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.”

Partnership means a lawful business owned by two or more persons. The profit of the business shared by the partners in agreed ratio. The liability of each partner is unlimited. Small and medium size business activities are performed under this organization. It has the following features:

- Legal Entity
- Profit and Loss Distribution
- Unlimited Liability
- Transfer of Rights
- Management
- Number of Partners

3. Joint Stock Company

According to S. E. Thomas, “A company is an incorporated association of persons formed usually for the pursuit of some commercial purposes”

A joint stock company is a voluntary association of persons created by law. It has a separate legal entity apart from its members. It can sue and be sued in its name. In the joint stock company, the work of organization begins before its incorporation by promoters and it continues after incorporation. The joint stock company has the following feature:

- Creation of Law
- Separate Legal Entity
- Limited Liability
- Transferability of shares
- Number of Members
- Common Seal

Lesson-2**RECORD KEEPING AND SOME BASIC CONCEPTS****Learning Objective**

The evolution of accounting stated in the previous lecture continues with a slight emphasis on how actual record keeping started? In addition, some basic concepts like capital, profit, and budget are also introduced.

Different Types of Business Entities

- **Commercial Organizations (Profit Oriented)**
 - Sole proprietor
 - Partnership
 - Limited companies
- **Non-Commercial Organizations (Non-Profit Oriented)**
 - NGO's (Non-government Organizations)
 - Trusts
 - Societies

The Basic Concept of Record Keeping

We can maintain a diary of transactions and note the daily transactions like sale, purchase etc. in it.

Problems Faced in Maintaining Diary of Transactions

- How will we come to know the income and expenses from various sources?
- We only have a sheet / page on which daily transactions are listed.
- We do not know which product is selling better and which is not.

Diary of Transactions

Transactions of Jan 20--	
P a r t i c u l a r s	Rs.
Sold 5 nos. of Item A	1,000
Purchased 10 nos. of Item B	(15,000)
Sold 1 no. of Item C	2,000
Electricity bill paid	(1,500)
Sold 1 no. of Item A	500
Sold 2 nos. of Item B	4,000
Sold 5 nos. of Item A	1,000
Purchased 10 nos. of Item B	(15,000)
Sold 1 no. of Item C	2,000
Telephone bill paid	(1,000)
Salary paid	(1,500)

Available Alternate

One can go through all the transactions at the end of the month and note different types of transactions on different pages. So that every page gives complete detail for a different type of transaction like sales of different products and expenses of different types

Now try to go through these transactions and separate transactions of different types.

But what if the number of transactions is large?

Is it really possible to go through hundreds or thousands of transactions at the month end and analyse them to obtain required results.

Cash and Credit Transactions

Sales and purchase are not always for cash. Some times the payment / receipt is delayed to a future date (Sale/purchase for “UDHAR”). The diary that we have discussed above, records cash transactions only. The “UDHAR” (credit) transactions may be noted in separate diary. Now we have two diaries one for cash and one for credit. We need to know total sales and purchases (both cash and credit) and other information like the amount that is payable and receivable.

How will we get our required results now?

Do we need another diary to combine information from both these diaries?

But when we receive or pay cash for the credit transactions will we again record the transactions on the day,

When cash is received or paid? If so, where to record?

So the problems keep on increasing with the size or volume of business. But one thing is becoming certain and that is that an accurate reflection of business transacted can only be obtained if both cash and credit transactions are recorded in such a manner that there is no duplication and yet the transactions are completely recorded. This is possible only under Commercial Accounting.

Commercial Accounting

Commercial Accounting is done through a system that is known as Double entry book keeping.

Single Entry and Double Entry Accounting

- **Single entry accounting/Cash accounting.**

This system records only cash movement of transactions and that too up to the extent of recording one aspect of the transactions.

This means that only receipt or payment of cash is recorded and no separate record is maintained (about the source of receipt and payment) as to from whom the cash was received or to whom it was paid.

- **Double entry book keeping/Commercial accounting.**

Double entry or commercial accounting system records both aspects of transaction i.e. receipt or payment and source of receipt or payment. It also records credit transactions i.e. recording of Electricity Bill or accruals of Salary payment etc.

This concept will be explained in detail in the next lectures but for the time being it should be noted that in cash accounting date of receipt / payment of actual cash is important while in commercial accounting

the date on which the expense is caused (whether paid or not) as well as the spreading of the cost of certain items over their useful life becomes important.

Capital

No business can run without money or resources being invested therein.

Whatever money or resources from ones' own pocket are put in a business is referred to as **CAPITAL**. Capital is the investment of the Owner in the business.

This capital or investment must earn a return or profit on its use even if it is coming out of ones' pocket. This return is also known as **PROFIT**. So no capital should be without a profit or a return.

Also, no Capital even if coming from the business owner can be without cost. Why? Because if the same sum that was used in a business was put in the bank or used to buy Defence Savings or National Savings Certificates, a certain amount of profit would have been earned. By putting this money in business, a return must be expected.

Money Value of Time

Another important concept to remember in all businesses is that of **MONEY VALUE OF TIME**.

Time spend by the owner also has value; he should be remunerated for it. (The time of the proprietor or business persons spent on the business is also a business cost and must be paid for by the business in addition to the profit). Why because, if the business person had employed somebody else in his place, the person would be paid a salary. Therefore, a business person's **time and money** both have costs attached to them. Nothing is free nor should be expected to be free of cost.

Goodwill

This is simply the value attached to the good reputation earned through good and clean conduct of business over a number of years. This good reputation also has a value and becomes part of investment in business

Is Cash in Hand our Profit?

Not unless we have deducted from cash sales it is the total amount of expenses that are accrued or are on credit and added to it to the sales made on credit for which cash is to be received at a later date. The simple equation for calculation of profit would thus be:

$$\text{Cash Sale} - \text{Cash Payment} + (\text{Credit Sale} - \text{Credit Expense})$$

Also remember that certain items have a long life and will be used during that time to earn more money for business. The cost of such items will as be spread over their life and also accounted for accordingly in the above equation. .

Budget

Budgeting is another important aspect of business planning. The budget is made to ensure that there is at least a balance between Income earned and the expenses incurred on earning this income in the first instance, and to provide a reasonable return on the capital used in the business. However, if there is a shortfall between of Income as against expense, it means that more is being spent and less earned. Decisions will be required to bring the situation to balance or if it cannot be so then to arrange for loans or more capital to ensure business continues. But business cannot be run on loans and these must be repaid.

Budget Is an Organization's Plan of a Future Period Expressed in Money Terms.

Lesson-3**SYSTEMS OF ACCOUNTING AND SOME BASIC TERMINOLOGIES****Learning Objective**

After studying this lecture, the students should be able to:

- Distinguish between **Cash Accounting** and **Accrual Accounting**;
- Understand what is
 - **Income**
 - **Expenses**
 - **Profit or Net Profit**
- Distinguish between **Cash in Hand** and **Profit**.
- Distinguish between **Capital Expenses** and **Revenue Expenses**; and
- Understand what is Liability?

Cash Accounting and Accrual Accounting**Cash Accounting**

It is the accounting system in which events are recorded when actual cash / cheque is received or paid.

Let's take the example of utility bills like electricity, telephone etc. The bill of January is received on 15th February and paid on 25th February. If the organization is following cash accounting practice it will record the expense of electricity / telephone on 25th February because the actual payment is made on that day. The same principle applies for income and other transactions as well i.e. income is recorded when cash is actually received instead recording when it is earned.

Accrual Accounting

It is the accounting system in which events are **recorded as and when they occur**.

This means that income is recorded when it is earned and expense is recorded when incurred i.e. the organization has obtained the benefit from it. Consider the above example. The electricity is utilized in the month of January so the expense should be recorded in the month of January. Similarly the company that is providing the electricity should record the income in the month of January.

Income

Income is **the value of goods or services** that a business charges from its customers.

Businesses can be distributed in two major categories. One that provides / sells goods and the other that provides services. If the organization is commercial then these goods or services will always be provided at some price. This price at which these goods / services are provided is the income of the organization, providing the goods / services.

Expenses

Expenses are the **costs incurred to earn revenue**.

In order to earn revenue, one has to spend some money such as the cost of goods that are sold or the money paid to the individuals who are providing services plus other costs. These costs that are incurred / spent by the business to earn the revenue are the expenses of the business.

Profit or Net Profit

Net income or Net Profit is the amount by which the income exceeds expenses in a specific time period.

OR

Profit is what is left of the income after all expenses (paid and incurred) have been deducted from it.

$$\text{Net Profit} = \text{Income} - \text{Expenses}$$

Cash in Hand and Profit

We have said that profit is what is left of income after deducting the expenses. Is it the income received in cash less the expenses paid in cash? Or do we have to consider other things as well? It can be explained with the help of following example.

A trader purchases some goods from a supplier for Rs. 1,500 and promises to pay in two weeks time. (Remember credit transactions from lecture 02). The same day he sells these to a customer for Rs. 2,000 who pays Rs. 1,000 and promises to pay the balance amount after one week. Now at the end of the day, the trader has Rs. 1,000 in his hand. After one week, he will have another Rs. 1,000 and he will pay Rs. 1,500 after two weeks.

What is profit? Is Rs. 1,000 that he has in his hand on day one is his profit.

The answer is No. He still has to receive Rs. 1,000 and pay Rs. 1,500 to the supplier plus any other expenses that he may have incurred in the process of this trade. His actual profit is Rs. 500 less any other expenses that he incurs, which is the difference of the total amount that he receives from customer and the amount that he pays to the supplier less other expenses.

What we understand from this example is that cash in hand is not always the profit. To work out the profit we have to consider the total income and total expenses irrespective of the fact that actual payment has been made or not.

Capital and Revenue Expenses

We have established, to calculate the profit, all expenses are deducted from income. Are all payments that we make are expenses and have to be deducted from the income?

Consider the different types of payments that could be made by a business organization. The payments could be for utility bills, salaries, fuel bills or purchase of vehicle, furniture etc. Out of the types discussed above utility bills, salaries and fuel bill are the payments for which the organisation has already enjoyed the benefit. Whereas vehicle and furniture are the types from which the company will derive the benefit for a long time. If the payment made for vehicles and furniture is subtracted from the income of the period in which payment was made, the profit for that period will be too low. Whereas, in the future period when the item will still be providing benefit to the company there will be no expense to match the benefit of that expense. This means that we have to distinguish between the payments / expenses that provide benefit to the company immediately and those that last for a longer period.

In accounting the **expenses that provide benefit immediately are called “Revenue Expenses” and those expenses whose benefit last for a longer period are called “Capital Expenses”**.

Liabilities

Liabilities are the **debts** and **obligations** of the business.

Liability is the obligation of the business to provide a benefit or asset on a future date. We have discussed credit transactions. Whenever a person purchases something on credit he promises to pay for the goods on a future date. This is his obligation to pay cash at a future date and thus it becomes his liability.

Lesson-4**SINGLE AND DOUBLE ENTRY RECORD KEEPING****Learning Objective**

- The objective of this lecture is to develop an understanding in the students about the basic concepts like:
 - The separate business entity
 - Single and double entry book-keeping
 - Debit and Credit
 - The dual aspect of a transaction
 - Accounting equation

Separate Entity Concept

In accounting, **'The Business' is treated independently** from the persons who own it. This means, although anything owned by the business belongs to the owners of the business and anything owed by the business is payable by the owners but for accounting purposes, we assume that the business is independent from its owners. This means, if the business purchases a machine or piece of equipment, business will own and obtain benefit from that machine or equipment. Likewise, if the business borrows money from 'someone' it will have to repay the money. This 'someone' includes even the owner of the business.

This treatment of the business independently from its owners is called the 'Separate Entity Concept'.

Single Entry Book-keeping

This is the conventional style of keeping records of financial transactions. In single entry book keeping system, as it is clear from the name, **only one aspect of the transaction is recorded.**

This actually is not a system but is a procedure by which small business concerns, like retailers and small shopkeepers, keep record of their sale / income. In this system, there are usually **two to three registers "Khata"**. In one register cash received from customers is recorded, whereas the other one is a person-wise record of goods sold on credit "*Udhar Khata*". There may or may not be a register of suppliers to whom money is payable. That means, only one aspect of transaction i.e. either cash receipt or the fact that money is receivable from someone is recorded.

Double Entry Book-keeping

The concept of double entry is based on the fact that every transaction has two aspects i.e. receiving a benefit and giving a benefit. ***The accounting system that records both the aspects of transaction in books of accounts is called double entry system.***

The account that receives the benefit is debited and the account that provides the benefit is credited. 'Debit' and 'Credit' are denoted by 'Dr' and 'Cr' respectively. The ultimate result of the system is that for every Debit (Dr) there is an equal Credit (Cr).

Single & Double Entry Book-keeping Distinguished

The double entry system is a more sophisticated, comprehensive and reliable form of single entry book keeping system.

- Single entry system records only one aspect of the transaction such as:
 - Cash received from sale is recorded in cash register only,
 - Goods sold on credit are recorded in the individual's account only,
 - When cash is received from the customer, to whom something was sold on credit, the receipt may just be recorded in the account of individual only.
- Double entry system records both the aspects of the transaction;

- When goods are sold on cash the two aspects of the transaction are – the seller has sold goods and received cash against them. The goods sold are benefit transferred to the purchaser (Credit) whereas the cash received is the benefit against the goods sold (Debit).
- When the goods are sold on credit the benefit given is the same i.e. goods sold but the benefit received is not cash but a right to receive cash from the customer. Therefore, in this case Debit is given to customer's account (account receivable) instead of cash.
- When cash is received from the customer the right to receive cash ceases. So, the benefit received is cash and benefit transferred is the right to receive cash. Here cash will be debited and customer will be credited.

Adopting the double entry accounting system can, therefore, have following benefits:

- Every transaction has equal Debit and Credit; hence the total of all Debit accounts will be equal to the total of all Credit accounts at any given time. This serves as a quick test of mathematical accuracy of book keeping.
- Since all aspects of transactions are recorded, therefore, the books are more informative. In the above example of trader, if he keeps records under double entry system will know the exact figure of total sale, cash in hand and receivable from customers from their respective accounts at any desired time.

Debit and Credit

Debit and Credit are two Latin words and as such it is difficult to say what do these mean. But we can develop an understanding as to what does these terms stand for.

Debit

It signifies the receiving of benefit. In simple words it is the left hand side. DEBIT is a record of an indebtedness; specifically an entry on the left-hand side of an account constituting an addition to an expense or asset account or a deduction from a revenue, net worth, or liability account.

Credit

It signifies the providing of a benefit. In simple words it is the right hand side. CREDIT, in accounting, is an accounting entry system that either decreases assets or increases liabilities; in general, it is an arrangement for deferred payment for goods and services.

Dual Aspect of Transactions

For every debit there is an equal credit. This is also called the *dual aspect of the transaction* i.e. every transaction has two aspects, debit and credit and they are always equal. This means that every transaction should have two-sided effect. For example Mr. A starts his business and he initially invests Rupees 100,000/- in cash for his business. Out of this cash following items are purchased in cash;

- A building for Rupees 50,000/-;
- Furniture for Rupees 10,000/-; and
- A vehicle for Rupees 15,000/-

This means that he has spent a total of Rupees 75,000/- and has left with Rupees 25,000 cash. We will apply the Dual Aspect Concept on these events from the viewpoint of business.

When Mr. A invested Rupees 100,000/-, the cash account benefited from him. The event will be recorded in the books of business as,

Debit	Cash	Rs.100, 000	
Credit	Mr. A		Rs.100, 000

Analyse the transaction. The account that received the benefit, in this case is the cash account, and the account that provided the benefit is that of Mr. A.

- Building purchased – The building account benefited from cash account

Debit	Building	Rs.50, 000	
Credit	Cash		Rs.50, 000

- Furniture purchased – The furniture account benefited from cash account

Debit	Furniture	Rs.10, 000	
Credit	Cash		Rs.10, 000

- Vehicle purchased – The vehicle account benefited from cash account

Debit	Vehicle	Rs.15, 000	
Credit	Cash		Rs.15, 000

Basic Principle of Double Entry

We can devise the basic principle of double entry book-keeping from our discussion to this point “Every Debit has a Credit” which means that “All Debits are always equal to All Credits”.

Assets

Assets are the **properties and possessions of the business.**

Properties and possessions can be of two types:

- **Tangible Assets** that have physical existence (are further divided into Fixed Assets and Current Assets)
- **Intangible Assets** that have no physical existence

Examples of both are as follows:

- Tangible Assets – Furniture, Vehicle etc.
- Intangible Assets – Patents, Copyrights, Goodwill etc.

Accounting Equation

From the above example, if the debits and credits are added up, the situation will be as follows:

Debits

Cash	Rs.100,000/-
Building	50,000/-
Furniture	10,000/-
Vehicle	15,000/-

Credits

Mr. A	Rs.100, 000/-
Cash	75,000/-

The total Equation becomes:

DEBITS	=	CREDITS
Cash + Building + Furniture + Vehicle	=	Cash + Mr. A
100000 + 50000 + 10000 + 15000	=	75000 + 100,000

Cash on Left Hand Side is Rupees 100,000/- and on Right Hand Side it is Rs.75, 000/-. If it is gathered on the Left Hand Side it will give a positive figure of Rupees 25,000/- (which you will notice is our balance of cash in hand). Now the equation becomes:

DEBITS	=	CREDITS
Cash + Building + Furniture+ Vehicle	=	Mr. A
25,000 + 50,000 + 10,000 + 15,000	=	100,000

Keeping the entity concept in mind we can see that the business owns the building, furniture, vehicle and cash and will obtain benefit from these things in future. Any thing that provides benefit to the business in future is called '**Asset**'. Similarly the business had obtained the money from Mr. A and this money will have to be returned in form of either cash or benefits. Any thing for which the business has to repay in any form is called '**Liability**'. So cash, building, furniture and vehicle are the assets of the business and the amount received from Mr. A for which the business will have to provide a return or benefit is the liability of the business. Therefore, our equation becomes:

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

The liabilities of the business can be classified into two major classes i.e. the amounts payable to 'outsiders' and those payable to the 'owners'. The liability of the business towards its owners is called '**Capital**' and amount payable to outsiders is called **liability**. Therefore, our accounting equation finally becomes:

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

Lesson-5**CLASSIFICATION OF ACCOUNTS****Learning Objective**

This lecture will cover

- Classification of accounts into Assets, Liabilities, Income and Expenses, and
- Rules of Debit and Credit for these classes.

Account

An accounting system keeps separate record of each item like assets, liabilities, etc. For example, a separate record is kept for cash that shows increase and decrease in it.

This **record that summarizes movement in an individual item is called an Account.**

Classification of Accounts

The accounts are classified into following heads:

- Assets
- Liabilities
- Income
- Expenses (further divided into capital and revenue expenses)

Assets

Assets are the **properties and possessions of the business to pay in future. Can be amount payable for material purchased, expenses etc.**

Properties and possessions can be of two types:

- **Tangible Assets** that have physical existence (are further divided into Fixed Assets and Current Assets).
- **Intangible Assets** that have no physical existence

Examples of both are as follows:

- Tangible Assets – Furniture, Vehicle etc.
- Intangible Assets – Right to receive money, Good will etc.

Liabilities

Liabilities are the **debts and obligations** of the business. Liability is the obligation of the business to provide a benefit or asset on a future date.

Asset is a right to receive and liability is an obligation to pay, therefore, these are opposite to each other.

Accounting Equation

Assets are created out of capital invested plus liability to third party.

$$\text{Assets} = \text{Liabilities} + \text{Owner's equity}$$

Income

Income / Revenue is **the value of goods or services** that a business charges from its customers Or the reward / return received from the resources committed in the business.

Expenses

Expenses are the **costs incurred to earn the revenue.** The resources spent and the efforts made to earn the income, when translated in money terms are the expenses of the business

Profit

Profit is the excess of income over expenses in a specific period.

Loss

Loss is the excess of expenses over income in a specific period.

Capital Expenditure

It is the expenditure to create an asset that helps in generating future income and its life is more than 12 month. For example machinery purchases, furniture purchases etc.

OR

Capital Expenditure is the amount used during a particular period to acquire or improve long-term assets such as property, plant or equipment.

Revenue Expenditure

It is the day to day expenses whose benefit is drawn immediately. For example, salary of the employee, rent of the building, etc.

OR

Revenue Expenditure is the cost of resources consumed or used up in the process of generating revenue, generally referred to as expenses.

Rules of Debit and Credit

From our discussion up to this point, we have established following rules for Debit and Credit:

Any account that obtains a benefit is Debit.

OR

Anything that will provide benefit to the business is Debit.

Both these statements may look different but in fact if we consider that whenever an account benefits as a result of a transaction, it will have to return that benefit to the business then both the statements will look like different sides of the same picture.

For credit,

Any account that provides a benefit is **Credit**.

OR

Anything to which the business has a responsibility to return a benefit in future is **Credit**.

As explained in the case of Debit, whenever an account provides benefit to the business the business will have a responsibility to return that benefit at some time in future and so it is Credit.

Rules of Debit and Credit for Assets

Similarly we have established that whenever a business transfers a value / benefit to an account and as a result creates some thing that will provide future benefit; the 'thing' is termed as **Asset**. By combining both these rules we can devise following rules of Debit and Credit for Assets:

- When an asset is created or purchased, value / benefit is transferred to that account, so it is Debited

i. Increase in Asset is Debit

- Reversing the above situation if the asset is sold, which is termed as disposing off, for say cash, the asset account provides benefit to the cash account. Therefore, the asset account is Credited

ii. Decrease in Asset is Credit

Rules of Debit and Credit for Liabilities

Anything that transfers value to the business, and in turn creates a responsibility on part of the business to return a benefit, is a **Liability**. Therefore, liabilities are the exact opposite of the assets.

- When a liability is created the benefit is provided to business by that account so it is Credited
 - iii. Increase in Liability is Credit**
- When the business returns the benefit or repays the liability, the liability account benefits from the business. So it is Debited
 - iv. Decrease in Liability is Debit**

Rules of Debit and Credit for Expenses

Just like assets, we have to pay for expenses. From assets, we draw benefit for a long time whereas the benefit from expenses is for a short run. Therefore, Expenditure is just like Asset but for a short run. Using our rule for Debit and Credit, when we pay cash for any expense that expense account benefits from cash, therefore, it is debited.

- Now we can lay down our rule for Expenditure:
 - v. Increase in Expenditure is Debit**
- Reversing the above situation, if we return any item that we had purchased, we will receive cash in return. Cash account will receive benefit from that Expenditure account. Therefore, Expenditure account will be credited
 - vi. Decrease in Expenditure is Credit**

Rules of Debit and Credit for Income

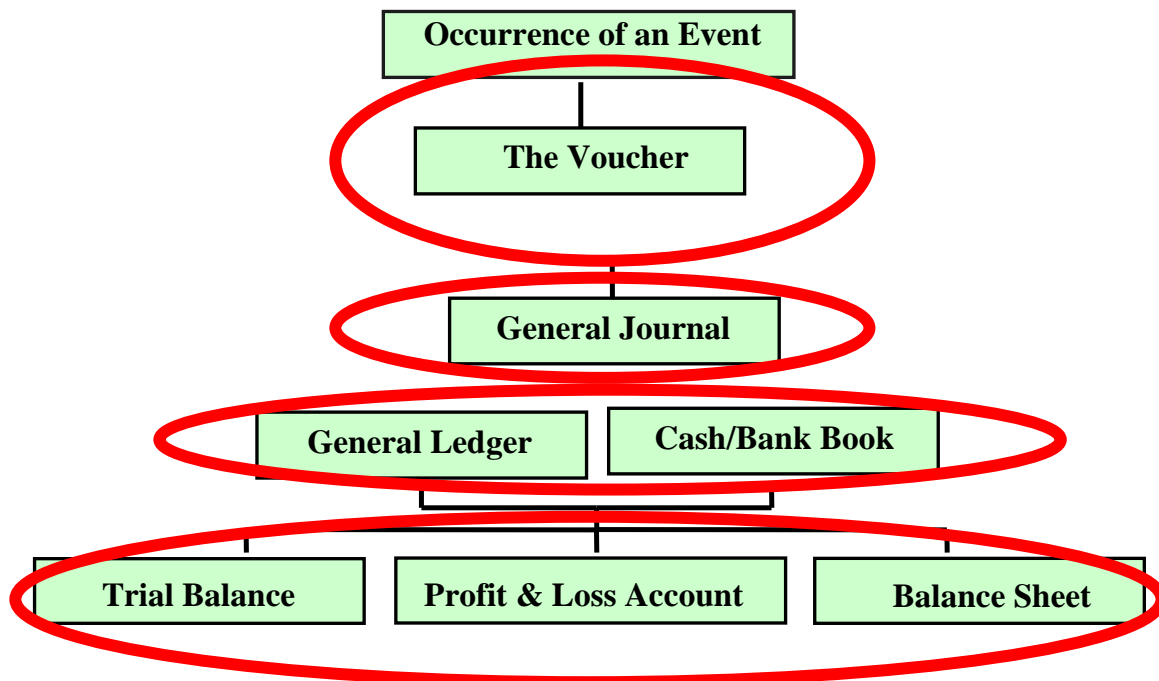
Income accounts are exactly opposite to expense accounts just as liabilities are opposite to that of assets. Therefore, using the same principle we can draw our rules of Debit and Credit for Income

- vii. Increase in Income is Credit**
- viii. Decrease in Income is Debit**

Lesson-6**FLOW OF TRANSACTIONS****Learning Objective**

This lecture will cover following areas:

- An overview of the flow of transactions.
- An introduction to the basic books of accounts.
- The General Ledger, and
- The ledger balance

The Flow of Transactions**Event**

Event is the happening of any thing but in accounting we discuss monetary events

Monetary Events

If the financial position of a business is change due to the happening of event that Event is called Monetary Event

The Voucher

Voucher is documentary evidence in a specific format that records the details of a transaction. It is accompanied by the evidence of transaction.

A Sample Voucher

Name Of Company			
Type Of Voucher			
Date: <u>1-1-20--</u>		No: <u>01</u>	
Description	Code #	Debit Amount	Credit Amount
Cash	01	100,000	
Capital	02		100,000
Total:		100,000	100,000
Narration:	Capital Introduced in Cash by Owner		
Prepared By:			Checked by:

The General Journal

The Journal is used to record financial transactions in chronological (day-to-day) order. All vouchers were first recorded in books of accounts. It was also called the Book of Original Entry or Day Book. But in present day accounting and especially with the introduction of computers for accounting, this book is not in use any more.

General Ledger – The ‘T’ Account

Ledger – is a book that keeps separate record for each account (Book of Accounts). The Account or Head of Account is systematic record of transactions of one type.

An account in its simplest form is a T-shape and looks like this:

Title of Account	
<p>Left hand side. The Debit side.</p>	<p>Right hand side. The Credit side.</p>

A Standard General Ledger

Since the ledger keeps record of transactions that affect one head of account, therefore, it should provide all the information that a user may need.

Usually the ledger is required to provide following information:

- Title of account
- Ledger page number, called Ledger Folio / Account Code
- Date of transaction
- Voucher number
- Narration / particulars of transaction
- Amount of transaction

A Standard General Ledger

Capital Account (Title of Account)			Account Code 02	
Date	Voucher Number	Particulars / Narration	Debit Amount	Credit Amount
20--				
Jan 01	01	Capital Account		100,000
		Capital Introduced in cash by Owner		

Recording From Voucher to General Ledger

Voucher				
Date: 1-1-20--			No: 01	
Description	Code #	Debit Amount	Credit Amount	
Cash account	01	100,000		
Capital account	02		100,000	
Narration:		Capital Introduced in Cash by Owner		

Capital Account (Title of Account)			Account code 02	
Date	Voucher Number	Particulars / Narration	Debit Amount	Credit Amount
20--				
Jan 01	01	Cash account		100,000

Completing the Recording – Both Effects

Description	Code #	Debit Amount	Credit Amount
Cash account	01	100,000	
Capital account	02		100,000
Narration:		Capital Introduced in Cash by Owner	

Capital Account Account Code 02				
Date	Voucher Number	Particulars / Narration	Debit Amount	Credit Amount
20--				
Jan 01	01	Cash account		100,000

Cash Account Account Code 01				
Date	Voucher Number	Particulars / Narration	Debit Amount	Credit Amount
20--				
Jan 01	01	Capital account	100,000	

A Simple Presentation of a Recorded Transaction is as under:

Cash Account	Code 01
Capital	
Capital Account Code 02	
	Cash 100,000

The Ledger Balance

In the earlier lecture, we have discussed that in order to have the total figure in respect of each head of expense/income, asset/liability, we need to maintain different accounts. We had also said that each account may have figures on the debit as well as on the credit side. Therefore, the difference between the debit and the credit sides, known as the ***BALANCE***, would represent the required total of the particular account.

The total of all balances on the Debit side is ALWAYS equal to the total of all balances on the Credit side. This is called the balancing of books of accounts. We will study about this concept at a later stage. The balance may be written out after every transaction in a third column or calculated at the end of a specific time period (an accounting period).

A Debit balance is shown without brackets and a Credit balance is shown in brackets (XYZ).

Cash Account		Account Code 01			
Date	Voucher Number	Narration / Particulars	Debit Amount	Credit Amount	Balance Dr/(Cr)
20--					
Jan 01	01	Capital account	100,000		100,000
Jan 01	02	Building account		50,000	50,000

Jan 02	03	Furniture account		10,000	40,000
Capital Account		Account Code 02			
Date	Voucher Number	Narration / Particulars	Debit Amount	Credit Amount	Balance Dr/(Cr)
20--					
Jan 01	01	Cash account		100,000	(100,000)

Lesson-7**BASIC BOOKS OF ACCOUNTS****Areas Covered in this lecture:**

- Cash book and bank book.
- Accounting Period.
- Trial Balance and its limitations.

Flow of Transactions:

In Financial Accounting, any business transaction flows as follows:

1. The business transaction is recorded in a **voucher**. The voucher is the first document prepared in the financial accounting.
2. All financial transactions are then posted in the **journal from vouchers**.
3. In these days, voucher is directly fed in the books of accounts by means of computers. Otherwise ledgers are prepared for each account from the Journal.
4. From the books of accounts, **trial balance** is prepared, which shows the arithmetic accuracy of the accounting system.
5. Finally, **financial statements**. i.e., Profit & Loss Account and Balance Sheet is prepared from trial balance.

Cash Book & Bank Book

Cash book and bank book are part of general ledger. All entries including payables and receivables are recorded in the general ledger. Expenses, income, assets and liabilities are recorded in different head of accounts to analyze the expenses incurred in different head of accounts. Due to large volume of transactions, entries related to cash and banks are recorded in the separate books.

Cash Book

All cash transactions (receipts and payments) are recorded in the cash book. Cash book balance shows the amount of cash in hand at a particular time.

Format of cash book is here under:

Cash Book					Account Code 01				
Receipt Side					Payment Side				
Date	No.	Narration / Particulars	Ledger Code	Receipt Amount	Date	No.	Narration / Particulars	Ledger Code	Payment Amount

OR

Cash Book				Account Code 01		
Date	Voucher Number	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)

Two formats of cash book are shown above. In the first format, receipt side and payment side are shown separately. In the second format, two columns are shown for receipt and payment with an extra column of balance. The balance column shows the net balance of cash available for use. The ledger code shows the code of that head of account which contains the second effect of the cash transactions because debits and credits are always equal in financial accounting.

Both of these formats are correct. A business can use any format considering its policies and requirements.

Bank Book

All bank transactions (receipts & payments) are recorded in the bank book. The balance of bank book reflects the cash available at bank at a particular time.

Format of bank book is hereunder:

Bank Book (Bank Account Number)				Account Code 02			
Date	Voucher Number	Chq. No.	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)

The format of bank book is same as that of cash book except the column of cheque no. This column is added in the format because all payments are made by cheque and the number of cheque is written in that column in order to keep the accounting record updated.

Accounting Period

Accounting period is any period for which a Financial Statements are prepared. The length of the accounting period can be anything between one day to one year. The legal or statutory definition of accounting year is a maximum of one year. The only exception in this case is the formation of a new company which is formed before the start of accounting period.

Financial year (A period of 12 month duration)

In Pakistan, financial year starts from 1st of July and ends on 30th of June. Exceptions are for specialized business such as textile mills, banks, Sugar mills etc. Financial reports can be made for a week or a month, depending upon the requirements of the company.

Debit & Credit Balances

It has already been mentioned that both sides i.e. Debit and credit side of a ledger must be equal. If debit side of a ledger is greater than credit side, the balance will be written on the credit side and it will be called

Debit Balance. The reason being, the balance is written on the credit side because of excessive debit balance. Therefore, it is called Debit Balance. For example:

Title of Account				Account Code 01			
Debit Side				Credit Side			
Date	No.	Narration / Particulars	Receipt Amount	Date	No.	Narration / Particulars	Payment Amount
	1		100,000		3		80,000
	2		20,000		4		30,000
			120,000				110,000
						Balance	10,000



Title of Account				Account Code 01			
Debit Side				Credit Side			
Date	No.	Narration / Particulars	Receipt Amount	Date	No.	Narration / Particulars	Payment Amount
	1		80,000		3		100,000
	2		30,000		4		20,000
			110,000				120,000
		Balance	10,000				


A Credit Balance

Similarly, if credit side is greater than debit side, the balance will be written on the debit side. This balance is called. **Credit Balance**. For Example:

Trial Balance

At the end of accounting period, a list of all ledger balances is prepared. This list is called trial Balance.

Trial balance is a listing of the accounts in your general ledger and their balances as of a specified date. A trial balance is usually prepared at the end of an accounting period and is used to see if additional adjustments are required to any of the balances. Since the basic accounting system relies on double-entry bookkeeping, a trial balance will have the same total debit amount as it has total credit amounts. Both sides of trial balance i.e. Debit side and credit side must be equal. If both sides are not equal, there are some errors in the books of accounts. Trial balance shows the mathematical accuracy of the books of accounts.

Limitations of Trial Balance

1. Trial balance only shows the mathematical accuracy of the accounts.
2. If both sides of trial balance are equal, books of accounts are considered to be correct. But this might not be true in all the cases.
3. If any transaction is not recorded at all, trial balance can not detect the omitted transaction.
4. If any transaction is recorded in the wrong head e.g. if an expense is debited to an assets account. Trial balance will not be able to detect that mistake too.

A Sample Trial Balance

Title Balance			
Trial Balance As on 31 st Dec. 200-----			
Title of Account	Account Code	Debit Amount	Credit Amount
Cash in Hand	01	xy	
Cash at bank	02	xy	
Capital	03		xy
Assets	04	xy	
Liabilities	05		xy
Income	06		xy
Expenses	07	xy	
Total		xyz	xyz

Lesson-8**INTRODUCTION TO FINANCIAL STATEMENTS****Learning Objective**

After studying this chapter, you will be able to:

- Draw up Profit & Loss account from the information given in trial balance.
- Differentiate the term, Receipt & Payment, Income & Expenditure and Profit & Loss account.

Financial Statements

Different reports generated from the books of accounts to provide information to the relevant persons. Every business is carried out to make profit. If it is not run successfully, it will sustain loss. The calculation of such profit & loss is probably the most important objective of the accounting function. Such information is acquired from “Financial Statements”. Financial Statements are the end product of the whole accounting process. These show us the profitability of the business concern and the financial position of the entity at a specified date. The most commonly used Financial Statements are ‘profit & loss account’ ‘balance sheet’ & ‘cash flow statement’.

Profit & Loss Account

Profit & Loss account is an account that summarizes the profitability of the organization for a specific accounting period.

Profit & Loss account has two parts:

- First part is called **Trading account** in which Gross Profit is calculated. Gross profit is the excess of sales over cost of goods sold in an accounting period. In trading concern, cost of goods sold is the cost of goods consumed plus any other charge paid in bringing the goods in salable condition. **For example**, if business purchased certain items for resale purpose and any expense is paid in respect of carriage or bringing the goods in store (transportation charges). These will also be grouped under the heading of ‘cost of goods sold’ and will become part of its price. In manufacturing concern, cost of goods sold comprises of purchase of raw material plus wages paid to staff employed for converting this raw material into finished goods plus any other expense in this connection.
- 2nd part is called **Profit & Loss account** in which Net Profit is calculated. **Net Profit** is what is left of the gross profit after deducting all other expenses of the organization in a specific time period.

How to prepare Profit & Loss Account?

One way is to write down all the Debit and Credit entries of Income and Expense accounts in the Profit and Loss Account. But it is not sensible to do so.

The other way is that we calculate the net balance or we can say Closing Balance of each income and expense account. Then we note all the credit balances on the credit side and all the debit balances on the debit of profit and loss account.

If the net balance of profit and loss is Credit (credit side is greater than debit side) it is Profit and if the net balance is Debit (Debit side is greater than credit side) it is a loss.

Income, Expenditure, Profit & Loss

Income is the value of goods and services earned from the operation of the business. It includes both cash & credit. **For example**, if a business entity deals in garments. What it earns from the sale of garments, is its income. If somebody is rendering services, what he earned from rendering services is his income.

Expenses are the resources and the efforts made to earn the income, translated in monetary terms. It includes both expenses, i.e., paid and to be paid (payable). Consider the above mentioned example, if any sum is spent in running the garments business effectively or in provision of services, is termed as expense.

Profit is the excess of income over expenses in a specified accounting period.

$$\text{Profit} = \text{Income} - \text{expenses}$$

In the above mentioned example, if the business or the services provider earn Rs. 100,000 & their expenses are Rs. 75,000. Their profit will be Rs. 25,000 (100,000-75,000).

Loss is the excess of expenses over income in a specified period of time. In the above example, if their expenses are Rs. 100,000 & their income is Rs. 75,000. Their loss will be Rs. 25,000.

Rules of Debit & Credit

Increase in expense is Debit (Dr.)

Decrease in expense is credit (Cr.)

Increase in income is credit (Cr.)

Decrease in income is Debit (Dr.)

Classification of Expenses

It has already been mentioned that a separate account is opened for each type of expense. Therefore, in large business concerns, there may be a large number of accounts in organization's books. As profit & loss account is a summarized record of the profitability of the organization. So, similar accounts should be grouped for reporting purposes.

The most commonly used groupings of expenses are as follows:

- Cost of goods sold
- Administration expenses
- Selling expenses
- Financial expenses

Cost of goods sold is the cost incurred in purchasing or manufacturing the product, which an organization is selling plus any other expense incurred in bringing the product in saleable condition. Cost of goods sold contains the following heads of accounts:

- Purchase of raw material/goods
- Wages paid to employees for manufacturing of goods
- Any tax/freight is paid on purchases
- Any expense incurred on carriage/transportation of purchased items.

Administrative expenses are the expenses incurred in running a business effectively. Main components of this group are:

- Payment of utility bills
- Payment of rent
- Salaries of employees
- General office expenses
- Repair & maintenance of office equipment & vehicles.

Selling expenses are the expenses incurred directly in connection with the sale of goods. This head contains:

- Transportation/carriage of goods sold
- Tax/freight paid on sale

If the expense head 'salaries' includes salaries of sales staff then it will be excluded from salaries & appear under the heading of 'selling expenses'.

Financial expenses are the interest paid on bank loan & charges deducted by bank on entity's bank accounts. It includes:

- Mark up on loan

- Bank charges

Receipt & Payment Account

A receipt & payment account is the summarized record of actual cash receipts and actual cash payment of the organization for a given period of time. This is a report that provides cash movement during the reported period. In other words, it can be defined as the summarized record of the cash book for a specific period.

Receipt & Payment Vs Profit & Loss Account

Receipt & payment account is the summarized record of actual cash receipts and actual cash payment during the period while profit & loss account also includes Receivable and Payable.

Income & Expenditure Vs Profit & Loss Account

These are two similar terms. Only difference between these two terms is that income & expenditure account is prepared for non profit oriented organizations, e.g. Trusts, NGO's, whereas profit & loss account is prepared in profit oriented organizations, e.g. Limited companies, Partnership firms etc. In case of Income and Expenditure account, Surplus/Deficit is to be find and in case of Profit and loss account, profit or loss is to be found.

A sample of Profit and Loss Account

Name of the Entity Profit and Loss Account For the period Ending ----			
DEBIT		CREDIT	
PARTICULARS	AMOUNT Rs.	PARTICULARS	AMOUNT Rs.
Cost of sale	60,000	Income	100,000
Gross profit c/d (Income – cost of sales)	40,000		
Total	100,000	Total	100,000
Admin expenses	15,000	Gross profit b/d	40,000
Selling expenses	5,000		
Financial expenses	5,000		
Net profit (Gross profit – expenses)	15,000		
Total	40,000	Total	40,000

Calculations of Gross profit and Net profit

$$\begin{aligned}
 \text{Gross profit} &= \text{Income} - \text{cost of sales} \\
 &= 100000 - 60000 \\
 &= 40000 \\
 \text{Net profit} &= \text{Gross profit} - \text{Expenses} \\
 &= 40000 - (15000 + 5000 + 5000) \\
 &= 15000
 \end{aligned}$$

A sample of Income Statement

Name of the Entity
Income statement
For the period Ending ----

PARTICULARS	AMOUNT Rs.	AMOUNT Rs
Income/Sales/Revenue		100000
Less: Cost of sales		(60000)
Gross profit		40000
Less: Administration expenses	15000	
Selling expenses	5000	
Financial expenses	5000	(25000)
Net profit		15000

Recognition of Income and Expenditure Account:

Income – should be recognized / recorded at the time when goods are sold or services are rendered.
Expenses – should be recognized / recorded when benefit relating to that expense has been drawn.

Lesson-9**INTRODUCTION TO FINANCIAL STATEMENTS (CONTINUED)****Learning Objective**

After studying this chapter, you should be able to:

- Explain what are Assets and Liabilities and
- Draw up simple Balance Sheet from given information in trial balance

Assets are economic resources that are owned by a business and are expected to benefit future operations. In most cases, the benefit to future operations comes in the form of positive future cash flows. The positive future cash flows may come directly as the asset is converted into cash (collection of a receivables) or indirectly as the asset is used in operating the business to create other assets that result in positive future cash flows (building & land used to manufacture a product for sale). Assets may have definite physical form such as building, machinery or stock. On the other hand, some assets exist not in physical or tangible form, but in the form of valuable legal claims or right. Examples are accounts receivables, investment in govt. bonds and patent rights etc.

Liabilities are debts and obligations of the business. The person or organization to which the debt is owed is called **creditors**. All businesses have liabilities; even the most successful companies' purchase stocks, supplies and receive services on credit. The liabilities arising from such purchases are called **Accounts payable**.

Rule of Debit and Credit for Assets and Liabilities

Assets (increase in assets is debit and decrease in asset is credit)

Liabilities (Increase in liability is credit and decrease in liability is debit)

Classification of Assets:

There are two types of assets:

1. **Tangible Assets** which have physical existence and can be seen or touched. It includes Fixed as well as Current assets.
2. **Intangible assets** which have no physical existence like goodwill, patents and copyrights etc.
 - **Fixed Assets** – Are the assets of permanent nature that a business acquires, such as plant, machinery, building, furniture, vehicles etc. Fixed assets are subject to depreciation.
 - **Long Term Assets** –These are the assets of the business that are receivable after twelve months of the balance sheet date. For example, if business has invested some money for two years in any saving scheme or has purchased saving certificates for more than one year, it is a long term asset.
 - **Current Assets** – Are the receivables that are expected to be received within one year of the balance sheet date. Debtors, closing stock & all accrued incomes are the examples of Current Assets because these are expected to be received within one accounting period from the balance sheet date.

The year, in which long term asset is expected to be received, long term asset is transferred to current assets in that year.

Classification of Liabilities

Capital – is the funds invested by the owners of the business. Business has a liability to return these funds to the owner. We know that for the purpose of accounting, business is treated separately from its owners. This is known as Separate Entity Concept i.e. Business is a separate entity. Therefore, if the

owner gives something (can be in form of Cash or Some other Asset) to the business then the business, not only has to return the amount to the owner but it also has to give some return on that money. That is why we treat Capital (Owners Funds) as a Liability.

Profit & Loss Account – The net balance of the profit and loss account i.e. either profit or loss also belongs to the owners.

While explaining capital we said that the business has to give return to the owners. Now if the business is managed successfully, then this return would be a Favorable figure (Profit). This return will, therefore, be added to the Owners' investment.

On the other hand, if the business is not managed successfully then this return would be an un-favorable figure (Loss). It will, therefore, be deducted from the Owners' Investment.

- **Long Term Liabilities** – These are the liabilities that will become payable after a period of more than one year of the balance sheet date. For example, if business has taken a loan from bank or any third person and it is payable after ten years, it will be treated as a long term liability for the business.
- **Current Liabilities** – These are the obligations of the business that are payable within twelve months of the balance sheet date. Creditors and all accrued expenses are the examples of current liabilities of the business because business is expected to pay these back within one accounting period.

The year in which long term liability is to be paid back, long term liability is transferred to current liability in that year.

Balance Sheet

It is a position statement that shows the standing of the organization in Monetary Terms at a Specific Time.

Unlike Profit and Loss that shows the performance of the entity over a period of time, the Balance Sheet shows the Financial State of Affairs of the entity at a given date. Balance sheet is the summarized analysis in a 'T' form of all assets and liabilities of the entity, with liabilities listed on left hand side and assets on right hand side. Asset is any owned physical object (tangible asset) or a right (intangible asset) having economic value to the owner. Liability is an obligation of the business to deliver goods or to provide a benefit in future.

Format of Balance Sheet (Account Form)

Name of the Entity Balance Sheet As At-----			
Liabilities	Amount Rs.	Assets	Amount Rs.
Capital	100,000	Fixes Assets	75,000
Add Net Profit	<u>15,000</u>	Long Term Assets	20,000
Long Term Liabilities	50,000	Current assets	80,000
Current liabilities	10,000		
Total	175,000	Total	175,000

Format of Balance Sheet (Report Form)

Name of the Entity Balance Sheet As At-----		
PARTICULARS	Amount Rs.	Amount Rs.
<u>ASSETS</u>		
Fixes Assets		75,000
Long Term Assets		20,000
Current Assets		80,000
Total		175,000
<u>LIABILITIES</u>		
Capital	100,000	
Add: Net Profit	15,000	115,000
Long Term Liabilities		50,000
Current Liabilities		10,000
Total		175,000

Illustration # 1

The following is the Trial Balance extracted from the books of Naeem & Sons as on 30/06/2002. Prepare a Profit & Loss account & Balance Sheet for the year ended June 30, 2002.

Particulars	Dr.	Cr.
Sales		100,000
Purchases	45,000	
purchase return		3,000
Salaries	12,000	
Rent	5,000	
Debtors	25,000	
Creditors		16,000
Capital		368,000
Plant & machinery	400,000	
Grand Total	487,000	487,000

Solution

Naeem & Sons			
Profit & Loss Account			
For the year ended June 30, 2002			
		Rs.	Rs.
			100,000
Cost of goods sold:			
Purchases	45,000		
Less: Purchase return	3,000	42,000	
Gross Profit		58,000	
		100,000	100,000
Salaries		12,000	58,000
Rent		5,000	
Net Profit		41,000	
		58,000	58,000

This is a presentation of Profit & Loss Account in ‘T’ account form. Now same illustration is presented in statement form.

Naeem & sons		
Profit & Loss Account for the year ended June 30, 2002		
Particulars	Amount Rs.	Amount Rs.
Income / Sales / Revenue		100,000
Less: Cost of Goods Sold		
Purchases	45,000	
Less: Purchase Return	(3,000)	(42,000)
Gross Profit		58,000
Less: Administrative expenses		
Salaries	(12,000)	
Rent	(5,000)	(17,000)
Net Profit		41,000

This is not a correct way to present Profit & Loss Account in statement form. In actual practice only main heads of expenses are presented in Profit & Loss Account along with foot note number. Detail of that head of expense is given in the note.

Correct presentation of Profit & Loss Account is hereunder:

Naeem & Sons		
Profit & Loss Account for the year ended June 30, 2002		
Particulars	Amount Rs.	Amount Rs.
Income / Sales / Revenue		100,000
Less: Cost of Goods Sold (See Note # 1)		(42,000)
Gross Profit		58,000
Less: Administrative expenses (See Note # 2)		(17,000)
Net Profit		41,000

Note # 1

Cost of goods sold

Purchases	45,000
Less: Purchase Return	(3,000)
Net Purchases	42,000

Note # 2

Administrative expenses

Salaries	12,000
Rent	5,000
Total Administrative expenses	17,000

It is recommended that Profit & Loss Account should be prepared in above mentioned format.

Balance Sheet

Naeem & Sons			
Balance Sheet As At June 30, 2002			
Liabilities		Assets	
Particulars	Amount Rs.	Particulars	Amount Rs.
Capital 368,000 Net Profit 41,000	409,000	Fixed Assets Plant & Machinery	400,000
Current Liabilities Creditors	16,000	Current Assets Debtors	25,000
Total	425,000	Total	425,000

Balance Sheet in statement form is presented hereunder:

Naeem & Sons		
Balance Sheet As At June 30, 2002		
Particulars	Amount Rs.	Amount Rs.
Assets		
Fixed Assets		
Plant & machinery		400,000
Current Assets		
Debtors		25,000
Total		425,000
Liabilities		
Capital	368,000	
Add: Net Profit	41,000	409,000
Current Liabilities		
Creditors		25,000
Total	425,000	425,000

Illustration # 2

The following Trial Balance has been extracted from the books of Saeed & Co. on 30-06-2002. From this, prepare an Income Statement and Balance Sheet for the year ended 30-06-2002.

Particulars	Dr. (Rs.)	Cr.(Rs.)
Sales		200,000
Purchases	180,000	
purchase return		2,500
Office salaries	3,500	
Furniture & Fixture	16,000	
Office Equipment	11,000	
Rent	5,000	
Accounts Payable(creditors)		28,000
Sales Salaries	3,000	
Freight & custom duty on purchases	6000	
Repair of office equipment	2,000	
Accounts Receivable(debtors)	52,000	
Freight on sales	1,000	
Capital		41,500
Cash in hand	37,000	
Loan from bank(for three years)		50,000
Bank charges	500	
Interest on loan	5,000	
Total	322,000	322,000

Solution

Saeed & Co.			
Profit & Loss Account for the year ended June 30, 2002.			
	Rs.		Rs.
Purchases	180,000	Sales	200,000
Freight, custom duty on purchases	6,000	Purchase return	2,500
Gross Profit	16,500		
	202,500		202,500
Salaries	3,500	Gross Profit	16,500
Rent	5,000		
Repair of office equipment	2,000		
Sales salaries	3,000		
Freight on sales	1,000		
Interest on loan	5,000		
Bank charges	500		
		Net loss	3,500
Total	20,000		20,000

Profit & Loss Account in statement form:

Particulars	Amount Rs.
Income / Sales / Revenue	200,000
Less: Cost of Goods Sold (See Note # 1)	(183,500)
Gross Profit	16,500
Less: Administrative expenses (See Note # 2)	(10,500)
Less: Selling expenses (See Note # 3)	(4,000)
Less: Financial Expenses (See Note # 4)	(5,500)
Net Profit/(Loss)	(3,500)

Note # 1**Cost of Goods Sold**

Purchases	180,000
Less: purchase return	(2,500)
Add: Freight, custom duty on purchases	6,000
Total	183,500

Note # 2**Administrative expenses**

Salaries	3,500
Rent	5,000
Repair of office equipment	2,000
Total	10,500

Note # 3**Selling expenses**

Sales salaries	3,000
Freight on sales	1,000
Total	4,000

Note # 4**Financial expenses**

Interest on loan	5,000
Bank charges	500
Total	5,500

Balance Sheet

Saeed & co.			
Balance Sheet As At June 30, 2002			
Liabilities		Assets	
Particulars	Amount Rs.	Particulars	Amount Rs.
Capital Add: Net Profit	41,500 (3,500)	Fixed Assets Furniture & Fixture	16,000
	38,000		
Long Term Liabilities Loan from bank	50,000	Current Assets Debtors	52,000
Current Liabilities Creditors	28,000	Office equipment	11,000
		Cash	37,000
Total	116,000	Total	116,000

Balance Sheet in statement form

Saeed & Co.		
Balance Sheet As At June 30, 2002		
Particulars	Amount Rs.	Amount Rs.
<u>Assets</u>		
Fixed Assets		
Furniture & Fixture		16,000
Current Assets		
Debtors		52,000
Office Equipment		11,000
Cash		37,000
Total		116,000
<u>Liabilities</u>		
Capital	41,500	
Profit/(Loss)	(3,500)	38,000
Long Term Liabilities		
Loan from bank		50,000
Current Liabilities		
Creditors		28,000
Total		116,000

Lesson-10**EXERCISES- RECORDING OF TRANSACTIONS**

Transactions of Ali Traders for the month of January:

No.	Date	Particulars
01	Jan 01	Started business with Rs. 200,000 in cash.
02	Jan 01	Opened a bank account and deposited Rs. 195,000 in it.
03	Jan 02	Paid for furniture Rs. 15,000 through cheque.
04	Jan 03	Paid for vehicle Rs. 50,000 through cheque.
05	Jan 05	Bought goods on credit from Mr. A for Rs. 50,000.
06	Jan 06	Sold goods for cash Rs. 60,000.
07	Jan 08	Purchased goods for cash Rs. 20,000.
08	Jan 10	Returned goods of Rs. 10,000 to Mr. A.
09	Jan 12	Sold goods on credit to Mr. B for Rs. 40,000.
10	Jan 18	Mr. B returned goods of Rs. 5,000.
11	Jan 21	Paid through cheque to Mr. A Rs. 25,000.
12	Jan 25	Mr. B Paid through cheque Rs. 20,000.
13	Jan 31	Paid Salaries through cheque Rs. 5,000.
14	Jan 31	Accrued expenses for the month Rs. 20,000.
15	Jan 31	Deposited in bank Rs. 10,000.

01 – Started business with Rs. 200,000 in cash.

Cash Account Code 01							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
01-01---	01	Capital a/c	200,000				

Capital Account Code 03							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				01-01---	01	Cash a/c	200,000

02 – Deposited Rs. 195,000 in bank.

Bank Account Code 02							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
01-01---	02	Cash a/c	195,000				

Cash Account Code 01							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				01-01---	02	Bank a/c	195,000

03 – Paid for furniture Rs. 15,000 through cheque.

Bank Account Code 02							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				02-01---	03	Furniture a/c	15,000

Furniture Account Code 04							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
02-01---	03	Bank a/c	15,000				

04 – Paid for vehicle Rs. 50,000 through cheque.

Vehicle		Account Code 05					
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
03-01---	04	Bank a/c	50,000				

Bank		Account Code 02					
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				03-01---	04	Vehicle a/c	50,000

05 – Bought goods on credit from Mr. A Rs. 50,000.

Purchases		Account Code 06					
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
05-01---	05	Mr. A	50,000				

Mr. A (Creditor)		Account Code 07					
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				05-01---	05	Purchases a/c	50,000

Creditor

A person or organization to whom money is payable by the business is called a creditor.

06 – Sold goods for cash Rs. 60,000.

Cash Account Code 01							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
06-01---	06	Sales a/c	60,000				

Sales Account Code 08							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				06-01---	06	Cash a/c	60,000

07 – Purchased goods for cash Rs. 20,000.

Purchases Account Code 06							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
08-01---	07	Cash a/c	20,000				

Cash Account Code 01							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				08-01---	07	Purchases a/c	20,000

08 – Returned goods of Rs. 10,000 to Mr. A.

Mr. A (Creditor) Account Code 07							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
10-01---	08	Purchase return	10,000				

Purchases return Account Code 06							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				10-01---	08	Mr.A	10,000

09 – Sold goods on credit to Mr. B for Rs. 40,000.

Sales Account Code 08							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				12-01---	09	Mr. B	40,000

Mr. B (Debtor) Account Code 09							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
12-01---	09	Sales a/c	40,000				

Debtor

A person or organization from whom money is receivable by the business is called a debtor.

10 – Mr. B returned goods of Rs. 5,000.

Sales return Account Code 08							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
18-01---	10	Mr. B	5,000				

Mr. B (Debtor) Account Code 09							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				18-01---	10	Sales return	5,000

11 – Paid through cheque to Mr. A Rs. 25,000.

Mr. A (Creditor) Account Code 07							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
21-01---	11	Bank a/c	25,000				

Bank Account Code 02							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				21-01---	11	Mr. A	25,000

12 – Mr. B Paid through cheque Rs. 20,000.

Bank Account Code 02							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
25-01---	12	Mr. B	20,000				

Mr. B (Debtor) Account Code 09							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				25-01---	12	Bank a/c	20,000

13 – Paid Salaries through cheque Rs. 5,000.

Salaries Account							Code 10
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
31-01---	13	Bank a/c	5,000				

Bank Account							Code 02
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				31-01---	13	Salaries a/c	5,000

14 – Accrued expenses for the month Rs. 20,000.

Expenses Account				Code 11			
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
31-01---	14	Accrued exp a/c	20,000				

Accrued Expenses / Expenses Payable Account				Code 12			
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				31-01---	14	Expense exp	20,000

15 – Deposited in bank Rs. 10,000.

Bank Account Code 02							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
31-01---	15	Cash a/c	10,000				

Cash Account Code 01							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				31-01---	15	Bank a/c	10,000

Bank Account

Bank Account Code 02							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
01-01---	02	Cash a/c	195,000	02-01---	03	Furniture a/c	15,000
25-01---	12	Mr. B	20,000	03-01---	04	Vehicle a/c	50,000
31-01---	15	Cash a/c	10,000	21-01---	11	Mr. A	25,000
				31-01---	13	Salaries a/c	5,000
						Balance	130,000

Lesson-11**EXERCISES- RECORDING OF TRANSACTIONS (Continued)****Cash Account**

Cash Account Code 01							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
01-01---	01	Capital a/c	200,000	01-01---	02	Cash a/c	195,000
06-01---	06	Sales a/c	60,000	08-01---	07	Purchases a/c	20,000
				31-01---	15	Cash a/c	10,000
							225,000
						Balance	35,000
			260,000				260,000

Name Of the Organization (Ali Traders)			
Trial Balance As On As on January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Total			

Bank Account

Bank Account Code 02							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
01-01---	02	Cash a/c	195,000	02-01---	03	Furniture a/c	15,000
25-01---	12	Mr. B	20,000	03-01---	04	Vehicle a/c	50,000
31-01---	15	Cash a/c	10,000	21-01---	11	Mr. A	25,000
				31-01---	13	Salaries a/c	5,000
							95,000
						Balance	130,000
			225,000				225,000

Name Of the Organization (Ali Traders)			
Trial Balance As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Total			

Capital Account

Capital Account Code 03							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				01-01---	01	Capital a/c	200,000
			0				
		Balance	200,000				
			200,000				200,000

Name Of the Organization (Ali Traders)			
Trial Balance As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Total			

Furniture Account

Furniture		Account Code 04					
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
02-01---	03	Furniture a/c	15,000				
						Balance	15,000
			15,000				15,000

Name Of the Organization (Ali Traders)			
Trial Balance As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Total			

Vehicle Account

Vehicle		Account Code 05					
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
03-01---	04	Furniture a/c	50,000				
						Balance	50,000
			50,000				50,000

Name Of the Organization (Ali Traders)			
Trial Balance As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Vehicle Account	05	50,000	
Total			

Purchases Account

Purchases Account Code 06							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
05-01---	05	Purchases a/c	50,000	10-01---	08	Purchase return	10,000
08-01---	07	Purchases a/c	20,000				
						Balance	60,000
			70,000				70,000

Name Of the Organization (Ali Traders)			
Trial Balance As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Vehicle Account	05	50,000	
Purchases Account	06	60,000	
Total			

Mr. A (Supplier)

Mr. A (Creditor)		Account Code 07					
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
10-01---	08	Purchase return	10,000	05-01---	05	Purchases a/c	50,000
21-01---	11	Bank a/c	25,000				
		Balance	15,000				
			50,000				50,000

Name Of the Organization (Ali Traders)			
Trial Balance			
As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Vehicle Account	05	50,000	
Purchases Account	06	60,000	
Mr. A (Creditor)	07		15,000
Total			

Sales

Sales Account Code 08							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
18-01---	10	Sales return	5,000	06-01---	06	Cash a/c	60,000
				12-01---	09	Mr. B a/c	40,000
		Balance	95,000				
			100,000				100,000

Name Of the Organization (Ali Traders)			
Trial Balance As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Vehicle Account	05	50,000	
Purchases Account	06	60,000	
Mr. A (Creditor)	07		15,000
Sales	08		95,000
Total			

Mr. B (Customer)

Mr. B (Debtor) Account Code 09							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
12-01---	09	Sales a/c	40,000	18-01---	10	Sales return	5,000
				25-01---	12	Bank a/c	20,000
						Balance	15,000
			40,000				40,000

Name Of the Organization (Ali Traders)			
Trial Balance As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Vehicle Account	05	50,000	

Purchases Account	06	60,000	
Mr. A (Creditor)	07		15,000
Sales	08		95,000
Mr. B (Debtor)	09	15,000	
Total			

Salaries

Salaries Account Code 10							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
31-01---	13	Cash a/c	5,000				
						Balance	5,000
			5,000				5,000

Name Of The Organization (Ali Traders)			
Trial Balance As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Vehicle Account	05	50,000	
Purchases Account	06	60,000	
Mr. A (Creditor)	07		15,000
Sales	08		95,000
Mr. B (Debtor)	09	15,000	
Salaries	10	5,000	
Total			

Expenses

Expenses		Account Code 11					
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
31-01---	14	Exp. accrued	20,000				
						Balance	20,000
			20,000				20,000

Name Of The Organization (Ali Traders)			
Trial Balance			
As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Vehicle Account	05	50,000	
Purchases Account	06	60,000	
Mr. A (Creditor)	07		15,000
Sales	08		95,000
Mr. B (Debtor)	09	15,000	
Salaries	10	5,000	
Expenses	11	20,000	
Total			

Expenses Payable

Expenses Payable Account Code 12							
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
				31-01---	14	Exp. accrued	20,000
		Balance	20,000				
			20,000				20,000

Name Of the Organization (Ali Traders)			
Trial Balance			
As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Vehicle Account	05	50,000	
Purchases Account	06	60,000	
Mr. A (Creditor)	07		15,000
Sales	08		95,000
Mr. B (Debtor)	09	15,000	
Salaries	10	5,000	
Expenses	11	20,000	
Expenses Payable	12		20,000
Total		330,000	330,000

Profit & Loss Account (Account Form)

Name of the Entity (Ali Traders)			
Profit and Loss Account For the Month Ending January 31, 20--			
Debit		Credit	
Particulars	Rs.	Particulars	Rs.
Cost of Sale (Purchases)	60,000	Income	95,000
Gross Profit (income – Cost of Sale)	35,000		
Total	95,000	Total	95,000
Admin Expenses Salaries 5,000 Expenses 20,000	25,000	Gross Profit	35,000
Net Profit (gross Profit – expenses)	10,000		
Total	35,000	Total	35,000

Profit & Loss Account (Report Form)

Name of the Entity (Ali Traders)		
Profit and Loss Account For the Month Ending January 31, 20--		
Particulars	Amount Rs.	Amount Rs.
Income / Sales / Revenue		95,000
Less: Cost of Goods Sold		(60,000)
Gross Profit		35,000
Less: Administrative Expenses	(25,000)	(25,000)
Net Profit		10,000

Rules of Debit & Credit

- Any account that obtains a benefit is Debit.
- Anything that will provide benefit to the business is Credit.
- Both these statements may look different but in fact if we consider that whenever an account benefits as a result of a transaction it will have to return that benefit to the business then both the statements will look like different sides of the same picture.

Rules of debit & credits can also be explained like:

- **Expenditure**
 - Increase in Expenditure is Debit
 - Decrease in Expenditure is Credit
- **Income**
 - Increase in Income is Credit
 - Decrease in Income is Debit
- **Assets**
 - Increase in Asset is Debit
 - Decrease in Asset is Credit
- **Liability**
 - Increase in Liability is Credit
 - Decrease in Liability is Debit

Now we will explain these rules with the help of the following illustration:

Sr. #	Date	Particulars
01	Jan 01	Mr. Rizwan invests Rs. 100,000 to commence his business.
02	Jan 03	He opened an account with bank & deposited Rs. 30,000.
03	Jan 05	He borrows Rs. 50,000 from Mr. Saleem at 12% per annum.
04	Jan 07	He purchased furniture worth Rs. 20,000 for cash.
05	Jan 09	He purchased goods (for resale) worth of Rs. 10,000 from Mr. Afzal on credit.
06	Jan 10	He sold goods for cash Rs. 5,000
07	Jan 12	He sold goods for Rs. 5,000 to Mr. Naeem on credit basis.
08	Jan 15	Cash deposited in bank Rs. 5,000
09	Jan 16	He purchased stationery for Rs. 3,000.
10	Jan 18	He purchased office equipment for Rs. 10,000 and paid by cheque.
11	Jan 19	He returned defective goods to Mr. Afzal worth Rs. 1,000.
12	Jan 25	Goods are returned by Mr. Naeem Rs. 500 to the business.
13	Jan 30	Cash paid to Mr. Afzal Rs. 9,000 in full settlement of his claim.
14	Jan 31	Cash received from Mr. Naeem Rs. 4,500 in full settlement of his account.
15	Jan 31	Cash withdrawn from the bank Rs. 500.

Now first document that we prepare in accounting is the voucher. We will record first entry in voucher, i.e.

Name Of Company			
Type Of Voucher			
Date: <u>1-1-02--</u>		No: <u>01</u>	
Description	Code #	Debit Amount	Credit Amount
Cash a/c	01	100,000	
To Capital a/c	02		100,000
Total:		100,000	100,000
Narration:	Capital Introduced in Cash by Mr. Rizwan.		
Prepared By:	Checked by:		

Same entry is presented in simpler form:

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
01-01-2002	Cash A/c	01	100,000	
	Capital A/c	02		100,000
	Capital Introduced in Cash by Mr. Rizwan			

In this case, cash account is debited because cash account has obtained benefit and Capital account is credited because business has obtained benefit because of capital account.

This statement can also be interpreted like this:

As cash is an asset and it is increased in this case, so cash is debited. Capital is a liability and increase in liability is credit. In this case capital is increased, hence it is credited.

Entry # 2

First, we will book this entry in voucher.

Name Of Company			
Type Of Voucher			
Date: <u>3-1-02--</u>		No: <u>01</u>	
Description	Code #	Debit Amount	Credit Amount
Bank a/c	03	30,000	
To Cash a/c	01		30,000
Total:		30,000	30,000
Narration:	Deposited cash in bank.		
Prepared By:	Checked by:		

Again, the same entry in simple form

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-01-2002	Bank A/c	03	30,000	
	Cash A/c	01		30,000
	Deposited cash in bank.			

Again, bank account is debited because bank account has obtained benefit and Cash account is credited because business has obtained benefit because of cash account.

This statement can also be interpreted like this:

As bank is an asset and it is increased in this case, so bank is debited. Cash is an asset and decrease in asset is credit. In this case cash is decreased, hence it is credited

From now onward, we will present entry in simple form

Entry # 3

Date	Particulars	Code #	Amount (Dr.) Rs.	Amount (Cr.) Rs.
05-01-2002	Cash A/c	01	50,000	
	Loan A/c	04		50,000
	Obtained loan from Mr. Saleem.			

Cash account is debited because cash account has obtained benefit and Loan account is credited because business has obtained benefit because of Loan account.

This statement can also be interpreted like this:

As cash is an asset and it is increased in this case, so cash is debited. Loan is a liability and increase in liability is credit. In this case Loan is increased, hence it is credited

Entry # 4

Date	Particulars	Code #	Amount (Dr.) Rs.	Amount (Cr.) Rs.
07-01-2002	Furniture A/c	05	20,000	
	Cash A/c	01		20,000
	Purchased furniture for cash			

Again, furniture account is debited because furniture account has obtained benefit and Cash account is credited because business has obtained benefit because of cash account.

This statement can also be interpreted like this:

As furniture is an asset and it is increased in this case, so furniture is debited. Cash is an asset and decrease in asset is credit. In this case cash is decreased, hence it is credited.

Entry # 5

Date	Particulars	Code #	Amount (Dr.) Rs.	Amount (Cr.) Rs.
09-01-2002	Purchases A/c	06	10,000	
	Mr. Afzal(Creditors) A/c	07		10,000
	Purchased goods from Mr. Afzal on credit			

Purchase account is debited because purchase account has obtained benefit and Creditors account is credited because business has obtained benefit because of Creditors account.

This statement can also be interpreted like this:

As purchase is an expense and it is increased in this case, so purchase is debited. Creditors are liabilities and increase in liability is credit. In this case Creditors are increased, hence it is credited.

Creditor is any third person or organization, to whom business has to pay in future.

Entry # 6

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
10-01-2002	Cash A/c	01	5,000	
	Sale A/c	08		5,000
	Sold goods for cash			

Cash account is debited because cash account has obtained benefit and Sale account is credited because business has obtained benefit because of Sale account.

This statement can also be interpreted like this:

As cash is an asset and it is increased in this case, so cash is debited. Sale is an income and increase in income is credit. In this case income is increased, hence it is credited

Entry # 7

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
12-01-2002	Mr. Naeem (Debtors) A/c	09	5,000	
	Sale A/c	08		5,000
	Sold goods to Mr. Naeem on credit			

Debtors account is debited because Debtors account has obtained benefit and Sale account is credited because business has obtained benefit because of Sale account.

This statement can also be interpreted like this:

As Debtors is an asset and it is increased in this case, so debtors account is debited. Sale is an income and increase in income is credit. In this case income is increased, hence it is credited

Debtor is any third person or organization, from whom cash is receivable by the business.

Entry # 8

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
15-01-2002	Bank A/c	03	5,000	
	Cash A/c	01		5,000
	Cash deposited in bank			

Entry # 9

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
16-01-2002	Stationery expense A/c	10	3,000	
	Cash A/c	01		3,000
	Stationery purchased for cash			

Stationery account is debited because stationery account has obtained benefit and Cash account is credited because business has obtained benefit because of Cash account.

This statement can also be interpreted like this:

As stationery is an expense and it is increased in this case, so stationery is debited. Cash is an asset and decrease in asset is credit. In this case Cash is decreased, hence it is credited

Entry # 10

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
18-01-2002	Office Equipment A/c	11	10,000	
	Bank A/c	03		10,000
	Office equipment purchased by cheque			

Office Equipment account is debited because Office Equipment account has obtained benefit and Bank account is credited because business has obtained benefit because of Bank account.

This statement can also be interpreted like this:

As Office Equipment is an asset and it is increased in this case, so Office Equipment is debited. Bank is an asset and decrease in asset is credit. In this case bank account is decreased, hence it is credited

Entry # 11

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
19-01-2002	Mr. Afzal (Creditors) A/C	07	1,000	
	Purchase return A/C	12		1,000
	Goods returned to Mr. Afzal (creditor)			

Creditors account is debited because Creditors account has obtained benefit and Purchase return account is credited because business has obtained benefit because of Purchase return account.

This statement can also be interpreted like this:

As Creditors is a liability and it is decreased in this case, so Creditors is debited. Purchase return is an expense and decrease in expense is credit, so it is credited.

Entry # 12

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
25-01-2002	Sales return A/C	13	500	
	Mr. Naeem(Debtors) A/C	09		500
	Goods returned by Mr. Naeem (Debtors)			

Sales return account is debited because Sales return account has obtained benefit and Debtors is credited because business has obtained benefit because of Debtors account.

This statement can also be interpreted like this:

As sales return is decrease in income and decrease in income is debit, so it is debited. Debtors account is decreased and decrease in asset is credit, so it is credited.

Entry # 13

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
30-01-2002	Mr. Afzal(Creditors) A/C	07	9,000	
	Cash A/C	01		9,000
	Cash paid to Mr. Afzal(Creditors)			

Entry # 14

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
31-01-2002	Cash A/C	01	4,500	
	Mr. Naeem(Debtors) A/C	09		4,500
	Cash received from Mr. Naeem(Debtors)			

Entry # 15

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
31-01-2002	Cash A/C	01	500	
	Bank A/C	03		500
	Cash withdrawn from bank			

Cash Book and Bank Book

Ledger is a book that keeps separate record for each account; the Account or Head of Account is a systematic record of transactions of one type; and Like other things, a separate account is also required to record the movements in cash (usually called cash in hand) and bank account (usually called cash at bank). If the volume of transactions is high then we can separate books for cash and bank account. These separate books for cash and bank account are called cash book and bank book respectively. The Cash Book records all the movements in the cash account.

A Cash Book would look like one of the two samples shown below:

Cash Book					Account Code 01				
Receipt Side					Payment Side				
Date	No.	Narration / Particulars	Ledger Code	Receipt Amount	Date	No.	Narration / Particulars	Ledger Code	Payment Amount

OR

Cash Book Account Code 01						
Date	Voucher Number	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)

The Cash Book

In the first format / presentation, receipts (Debits) are written on left hand side of the page and payments (Credits) on the right hand side. In the second presentation, instead of using two pages, we use two columns on the same page. Both these presentations are correct. In the second format, we have an additional facility of knowing the balance of the account after every transaction. Whereas in the first one, we have to add up the receipts and payments every time we need to know the balance. Moreover, the second format utilizes less space, therefore, **we will use this format in our future discussions**

The Bank Book

The Bank book records all the movements in the bank account. The format of the bank book is the same as that of cash book except for an additional column for Cheque Number. Again, we can use either two pages OR two columns to present the bank book.

Bank Book (Bank Account Number) Account Code 02							
Date	Voucher Number	Chq. No.	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)

As you can see that except for a few minor differences, the format of Cash and Bank book are almost similar to that of the General Ledger.

The differences are explained here:

- The title of debit and credit columns has been changed to receipt and payment respectively. It is not necessary to make this change. But, it is done to simplify things as we know that in case of cash and bank, debit side would signify receipt and credit side would represent payment.
- There is an additional column titled ledger code. In this column, we write the code of the other head of account that is affected by the transaction. This helps in understanding the complete transaction at a glance.
- There may be a column for cheque number in the bank book.
- It may be noted that in case the organization operates more than one bank account, separate ledger accounts will be opened in bank book for each account.

Now we will summarize all cash transactions in both two page cash book & one page cash book for the convenience of the reader.

Two page cash book will be presented as under:

Cash Account Account Code 01									
Receipt Side					Payment Side				
Date	No.	Narration / Particulars	Ledger Code	Receipt Amount	Date	No.	Narration / Particulars	Ledger Code	Payment Amount
Jan-1		Capital introduced	02	100,000	Jan-3		Deposited in bank	03	30,000
Jan-5		Loan received	04	50,000	Jan-7		Furniture purchased	05	20,000
Jan-10		Goods sold	08	5,000	Jan-15		Deposited in bank	03	5,000
Jan-31		Received from debtors	09	4,500	Jan-16		Stationery purchased	10	3,000
Jan-31		Cash drawn from bank	03	500	Jan-30		Paid to creditors	07	9,000

Same record will be presented in two column cash book now

Date	Voucher Number	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)
Jan-1		Capital introduced	02	100,000		100,000
Jan-3		Deposited in bank	03		(30,000)	70,000
Jan-5		Loan received	04	50,000		120,000
Jan-7		Furniture purchased	05		(20,000)	100,000
Jan-10		Goods sold	08	5,000		105,000
Jan-15		Deposited in bank	03		(5,000)	100,000
Jan-16		Stationery purchased	10		(3,000)	97,000
Jan-30		Paid to creditors	07		(9,000)	88,000
Jan-31		Received from debtors	09	4,500		92,500
Jan-31		Cash drawn from bank	03	500		93,000

Now, we will present Bank entries in bank book.

Bank Book (Bank Account # xxx) Account Code 02							
Date	Voucher Number	Chq. No.	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)
Jan-3			Cash deposited	01	30,000		30,000
Jan-15			Cash deposited	01	5,000		35,000
Jan-18			Off. Equip. purchased	11		(10,000)	25,000
Jan-31			Cash drawn	01		(500)	24,500

Recommended readings:

- Chapter # 2 of Business Accounting by Frank Woods
- Chapter # 2, 3 of Accounting by M. Arif & Sohail Afzal

Illustration

Nawab Sons started their business in the month of March, 2002. Following are their transactions for the month. Pass journal entries, prepare Ledger Accounts, and make their profitability analyses.

Sr. #	Date	Particulars
01	Mar. 01	Started business with Rs. 150,000
02	Mar. 05	Purchased office furniture for cash Rs. 2,000
03	Mar. 07	Purchased goods for cash Rs. 9,000
04	Mar. 10	Paid carriage on purchases Rs. 250
05	Mar. 12	Purchased goods from Saleem & co. Rs. 7,000
06	Mar. 13	Sold goods for cash Rs. 12,000
07	Mar. 15	Sold goods to Usman & Sons Rs. 25,000
08	Mar. 21	Received cash From Usman & Sons Rs. 25,000
09	Mar. 21	Paid cash to Saleem & co Rs. 7,000
10	Mar. 23	Paid salaries for the month Rs. 2,500
11	Mar. 25	Paid rent Rs. 3,000
12	Mar. 29	Purchased stationery Rs.2,000
13	Mar. 31	Utility bills are accrued Rs. 5,000

Journal Entries**Entry # 1**

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-01-2002	Cash A/c	01	150,000	
	Capital A/c	02		150,000
	Started business with cash.			

Entry # 2

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-05-2002	Office Furniture A/c	03	2,000	
	Cash A/c	01		2,000
	Purchased office furniture			

Entry # 3

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-07-2002	Purchases A/c	04	9,000	
	Cash A/c	01		9,000
	Purchased goods for cash.			

Entry # 4

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-10-2002	Carriage on purchase A/c	05	250	
	Cash A/c	01		250
	Paid carriage on purchase.			

Entry # 5

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-12-2002	Purchases A/c	04	7,000	
	Salim & co.(Creditors)	06		7,000
	Purchased goods on credit			

Entry # 6

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-13-2002	Cash A/c	01	12,000	
	Sale A/c	07		12,000
	Goods sold for cash.			

Entry # 7

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-15-2002	Usman & Sons (Debtors) A/c	08	25,000	
	Sale A/c	07		25,000
	Goods sold on credit.			

Entry # 8

Date	Particulars	Code #	Amount (Dr.) Rs.	Amount (Cr.) Rs.
03-21-2002	Cash A/c	01	25,000	
	Usman & Sons (Debtors A/c	08		25,000
	Cash received from Usman & Sons			

Entry # 9

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-21-2002	Salim & co.(Creditors) A/c	06	7,000	
	Cash A/c	01		7,000
	Paid cash to Salim & co.			

Entry # 10

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-23-2002	Salaries A/c	09	2,500	
	Cash A/c	01		2,500
	Started business with cash.			

Entry # 11

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-25-2002	Rent A/c	10	3,000	
	Cash A/c	01		3,000
	Paid rent.			

Entry # 12

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-29-2002	Stationery A/c	11	2,000	
	Cash A/c	01		2,000
	Stationery purchased.			

Entry # 13

Date	Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
03-31-2002	Utility Bills A/c	12	5,000	
	Accrued Expenses A/c	13		5,000
	Accrual of utility bills for the month..			

Ledger Accounts

Cash Account (Account code # 1)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
1-3-02	Capital a/c	02	150,000	5-3-02	Office furniture a/c	03	2,000
13-3-02	Goods sold	07	12,000	7-3-02	Purchases a/c	04	9,000
21-3-02	Received from debtors	08	25,000	10-3-02	Carriage	05	250
				21-3-02	Paid to creditors	06	7,000
				23-3-02	Salaries a/c	09	2,500
				25-3-02	Rent a/c	10	3,000
				29-3-02	Stationery a/c	11	2,000
					Balance		161,250
	Total		187,000		Total		187,000

Capital Account (Account code # 2)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
				1/3/2002	Cash a/c	1	150,000
	Balance		150,000				
	Total		150,000		Total		150,000

Office furniture Account (Account code # 3)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
	Office furniture	1	2,000				
					Balance	2,000	
	Total		2,000		Total		2,000

Purchases Account (Account code # 4)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
7-3-02	Cash	01	9,000				
12-3-02	Slim & Co(A/P)		7,000				
					Balance		16,000
	Total		16,000		Total		16,000

Carriage on purchase Account (Account code # 5)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
10-3-02	Cash	01	250				
					Balance		250
	Total		250		Total		250

Salim & co.(Creditors) Account (Account code # 6)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
12-3-02	Cash a/c	04	7,000	21-3-02	Purchases a/c	01	7,000
					Balance		0
	Total		7,000		Total		7,000

Sale Account (Account code # 7)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
				13-3-02	Cash a/c	01	12,000
	Balance		37,000	15-3-02	Usman & Sons (Debtors) a/c	08	25,000
	Total		37,000		Total		37,000

Usman & sons(Debtors) Account (Account code # 8)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
15-3-02	Sales a/c	07	25,000	21-3-02	Cash a/c	01	25,000
					Balance		0
	Total		25,000		Total		25,000

Salaries Account (Account code # 9)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
23-3-02	Cash a/c	01	2,500				
					Balance		2,500
	Total		2,500		Total		2,500

Rent Account (Account code # 10)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
25-3-02	Cash a/c	01	3,000				
					Balance		3,000
	Total		3,000		Total		3,000

Stationery Account (Account code # 11)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
29-3-02	Cash a/c	01	2,000				
					Balance		2,000
	Total		2,000		Total		2,000

Utility Bills Account (Account code # 12)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31-3-02	A/P	13	5,000				
					Balance		5,000
	Total		5,000		Total		5,000

Accrued Expenses Account (Account code # 13)							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31-3-02					A/P	12	5,000
	Balance		5,000				
	Total		5,000		Total		5,000

Trial Balance

Saeed & co.			
Trial Balance			
As On January 31, 2002			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	161,250	
Capital Account	02		150,000
Furniture Account	03	2,000	
Purchases Account	04	16,000	
Carriage on purchase account	05	250	
Salim& co. (Creditor)	06		0
Sales	07		37,000
Usman & co. (Debtor)	08	0	
Salaries	09	2,500	
Rent	10	3,000	
Stationery	11	2,000	
Utility bills	12	5,000	
Accrued expenses	13		5,000
Total		192,000	192,000

Saeed & Co.		
Profit & Loss Account for the period ended January 31, 2002		
Particulars	Amount Rs.	Amount Rs.
Income / Sales / Revenue (See Note #1)		37,000
Less: Cost of Goods Sold (See Note # 1)		(16,250)
Gross Profit		20,750
Less: Admin. Expenses (See Note # 2)		(12,500)
Net Profit/ (Loss)		8,250

Note # 1 Cost of goods sold

Purchases	16,000
Add: carriage on purchase	250
Cost of goods sold	16,250

Note # 2 Admin. Expenses

Salaries	2,500
Rent	3,000
Stationery	2,000
Utility bills	5,000
Total Administrative Expenses	12,500

Recommended readings:

- Chapter # 3 of business accounting by Frank Woods
- Chapter # 5 of accounting by M. Arif & Sohail Afzal.

Lesson-12**THE ACCOUNTING EQUATION**

Resources in the business = Resources supplied by the owner

In accounting, terms are used to describe things. The amount of resources supplied by the owner is called **capital**. The actual resources which are in the business are called **assets**. This means that the accounting equation above, when the owner has supplied all the resources, can be shown as:

Assets = Capital

Usually, people, other than the owner has supplied some of the assets. **Liabilities** are the name given to the amounts owing to these people for these assets. The equation has now changed to:

Assets = Capital + Liabilities

It can be seen that two sides of the equation will have the same totals. This is because we are dealing with the same thing with two different points of view. It is:

Resources in the business = Resources: who supplied them

Assets = Capital + Liabilities

It is a fact that total of each side will always equal one another, and this will always be true no matter how many transactions there may be. The actual assets, capital and liabilities may change, but the total of the assets will always equal to the total of capital and liabilities.

Assets consist of property of all kinds, such as buildings, machinery, stocks of goods and motor vehicles. Also benefits such as debts owned by customers and the amount of money in the bank accounts are included.

Liabilities consist of money owing for goods supplied to the business and for expenses. Also loans made to the firm are included.

Capital is often called the owner's net worth.

Working capital

Working capital of the business is the net value of current assets & current liabilities.

Current assets are the resources of the business that are expected to be received within 12 months in an accounting period.

Current liabilities are the amount owing to the business that is expected to be paid within one year in a financial year.

So, working capital is the net of what is receivable in an accounting year & what is payable in that year.

Working Capital = Current Assets – Current Liabilities

Example: current assets of the business worth Rs.100, 000 & current liabilities of the business has the value of Rs. 75,000. Then working capital will be Rs. 25,000 (100,000-75,000).

Stock

Stock is termed as “value of goods available to the business that are ready for sale”. For accounting purposes, stock is of two types:

- Opening stock
- Closing stock

Opening stock is the value of goods available for sale in the beginning of an accounting year. For purpose of financial reporting, opening stock is added to the purchases for the year to become a part of

cost of goods sold. As this is available in the beginning of the year, it is assumed that it will be consumed in the accounting year. That is why; it becomes a part of **cost of goods sold**. Closing Stock of previous year is the opening stock in present year (current year).

Closing stock is the value of goods unsold at the end of accounting year. For purposes of making financial statements, it is deducted from cost of goods sold & is shown as an asset in the **Balance Sheet**. As this is the value of goods that are yet to be sold, so it cannot be included in cost of goods sold. That is why it is deducted from cost of good sold. On the other hand, its benefit will be received in the next accounting year, so it is shown as an asset in the balance sheet.

The contents of cost of goods sold are:

Opening stock
 Plus: purchases
 Plus: Freight/ carriage paid on purchases
 Less: closing stock

Example: opening stock of a business worth Rs. 15,000, business purchased goods of Rs. 12,000 for the year & also paid Rs. 1,500 as carriage on purchases. The value of closing stock at the end of the year is Rs. 10,000. Then, value of closing stock will be calculated as under:

Opening stock	15,000
Add: purchases	12,000
Add: carriage on purchase	1,500
Less: closing stock	(10,000)
Cost of goods sold	18,500

Ali Traders			
Trial Balance			
As On January 31, 20--			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	35,000	
Bank Account	02	130,000	
Capital Account	03		200,000
Furniture Account	04	15,000	
Vehicle Account	05	50,000	
Purchases Account	06	60,000	
Mr. A (Creditor)	07		15,000
Sales	08		95,000
Mr. B (Debtor)	09	15,000	
Salaries	10	5,000	
Expenses	11	20,000	
Expenses Payable	12		20,000
Total		330,000	330,000

According to the Accounting equation,

Assets = Capital + Liabilities

Assets = 35,000+130,000+15,000+50,000+15,000= **245,000**

Capital = **200,000**

Liabilities = 15,000 + 20,000 = **35,000**

Capital + Liabilities = **235,000**

We have ignored the Net Profit Rs.10000 (Net profit is a part of the capital and will be added in capital account)

When we added Net profit in capital then;

Assets = Capital + Liabilities

245000 = 210000+35000

245000 = 245000

Account form Balance Sheet:

Name of the Entity (Ali Traders)			
Balance Sheet			
As at January 31, 20--			
Liabilities & Equity		Assets	
Particulars	Amount Rs.	Particulars	Amount Rs.
Capital	200,000	Fixed Assets	
Profit and Loss Account	10,000	Furniture	15,000
	210,000	Vehicle	50,000
<u>Current Liabilities</u>		<u>Current Assets</u>	
Mr. A 15,000		Mr. B	
Exp. payable <u>20,000</u>	35,000	15,000	
		Bank	180,000
		130,000	
		Cash	
		<u>35,000</u>	
Total	245,000	Total	245,000

Report form Balance Sheet:

Ali Traders		
Balance Sheet		
As At January 31, 20--		
Particulars	Amount Rs.	Amount Rs.
Assets		
Fixed Assets		65,000
Current Assets		180,000
Total		245,000
Liabilities		
Capital	200,000	
Profit and Loss Account	10,000	210,000
Current Liabilities		35,000
Total		245,000

Treatment of closing stock: If closing stock is Rs.1,000 then:

Name of the Entity (Ali Traders)		
Profit and Loss Account		
For the Month Ending January 31, 20--		
Particulars	Amount Rs.	Amount Rs.
Income / Sales / Revenue		95,000
Less: Cost of Goods Sold (60,000 - 1,000)	(59,000)	(59,000)
Gross Profit		36,000
Less: Administrative Expenses	(25,000)	(25,000)
Net Profit		11,000

Ali Traders		
Balance Sheet		
As At January 31, 20--		
Particulars	Amount Rs.	Amount Rs.
Assets		
Fixed Assets		65,000
Current Assets (180,000 + 1,000)		181,000
Total		246,000
Liabilities		
Capital	200,000	
Profit and Loss Account	<u>11,000</u>	211,000
Current Liabilities		35,000
Total		246,000

**Treatment
Depreciation:**

of

In Profit and Loss Account, it is considered as expense and in Balance Sheet it is deducted from the concerned fixed asset.

If useful life of an asset is 50 month and considered that there is no residual value then,

- By dividing total cost by life of the asset.
- Rs.65,000 / 50 months = Rs.1,300 monthly charge (Depreciation)

Name of the Entity (Ali Traders)		
Profit and Loss Account		
For the Month Ending January 31, 20--		
Particulars	Amount Rs.	Amount Rs.
Income / Sales / Revenue		95,000
Less: Cost of Goods Sold (60,000-1,000)	59,000	(59,000)
Gross Profit		36,000
Less: Administrative Expenses	25,000	
Depreciation	<u>1,300</u>	(26,300)
Net Profit		9,700

Ali Traders		
Balance Sheet		
As At January 31, 20--		
Particulars	Amount Rs.	Amount Rs.
<u>Assets</u>		
Fixed Assets (65,000 – 1,300)		63,700
Current Assets (180,000 + 1,000)		181,000
Total		244,700
<u>Liabilities</u>		
Capital	200,000	
Profit and Loss Account	<u>9,700</u>	209,700
Current Liabilities		35,000
Total		244,700

Distribution of Profits / Drawing

Ali traders		
Balance Sheet		
As At January 31, 20--		
Particulars	Amount Rs.	Amount Rs.
<u>Assets</u>		
Fixed Assets (65,000 – 1300)		63,700
Current Assets (181,000 - 5,000)		176,000
Total		239,700
<u>Liabilities</u>		
Capital	200,000	
Profit and Loss Account	9,700	
Drawing	<u>(5,000)</u>	204,700
Current Liabilities		35,000
Total		239,700

Illustration:

Consider the Trial Balance given hereunder:

Saeed & co.			
Trial Balance			
As on January 31, 2002			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	161,250	
Capital Account	02		150,000
Furniture Account	03	2,000	
Purchases Account	04	16,000	
Carriage on purchase account	05	250	
Salim& co. (Creditor)	06		0
Sales	07		37,000

Usman & co. (Debtor)	08	0	
Salaries	09	2,500	
Rent	10	3,000	
Stationery	11	2,000	
Utility bills	12	5,000	
Accrued expenses	13		5,000
Total		192,000	192,000

This Trial Balance is extracted from the solved illustration, in lecture 11.

Let's say, the value of closing stock at the end of the period is Rs. 2,000. Then Profit & Loss Account will bear the following change.

Saeed & Co.		
Profit & Loss Account		
For the period ended January 31, 2002		
Particulars	Amount Rs.	Amount Rs.
Income / Sales / Revenue (See Note #1) Less: (Cost of Goods Sold - Closing stock)	=16,250 – 2,000	37,000 (14,250)
Gross Profit Less: Admin. Expenses (See Note # 2)		22,750 (12,500)
Net Profit/ (Loss)		10,250

Its effect in the Balance Sheet is as follows:

Saeed & Co.			
Balance Sheet			
As At January 31, 2002			
Liabilities		Assets	
Particulars	Amount Rs.	Particulars	Amount Rs.
Capital	150,000	Fixed Assets	
Add: Net Profit	10,250	Furniture Account	2,000
	160,250		
Current Liabilities		Current Assets	
Accrued Expenses	5,000	Cash	161,250
		Closing Stock	2,000
Total	165,250	Total	165,250

This is a practical demonstration of the treatment of closing stock. But, we are not mentioning the journal entry of closing stock at this stage. It will be discussed in detail, when we will study the topic of fixed assets.

Depreciation

Depreciation is the method of charging cost of fixed assets to the profit & loss account as an expense.

Fixed Assets are those assets which are:

- Of long life
- To be used in the business
- Not bought with the main purpose of resale.

When an expense is incurred, it is charged to profit & loss account of the same accounting period in which it has incurred. Fixed assets are used for longer period of time. Now, the question is how to charge a fixed asset to profit & loss account. For this purpose, estimated life of the asset is determined.

Estimated life is the number of years in which a fixed asset is expected to be used. Then, total cost of the asset is divided by total number of estimated years. The value, so determined, is called 'depreciation for that year' and is charged to profit & loss account. The same amount is deducted from total cost of fixed asset. The net amount (after deducting depreciation) is called "Written down Value".

Example: An asset has a cost of Rs. 150,000. It is expected to be used for ten years. Depreciation to be charged to profit & loss account is Rs. 15,000 (Cost of asset/estimated life). In this case, it will be $150,000/10 = 15,000$.

That is why depreciation is called an accounting estimate.

To understand its accounting treatment, consider the above mentioned illustration:

Let's suppose the useful life of furniture is five years. Then, depreciation for the year will be $(2,000/5 = 400)$. Now, the profit & loss account will show the following picture:

Saeed & Co.		
Profit & Loss Account		
For the year ended January 31, 2002		
Particulars	Amount Rs.	Amount Rs.
Income / Sales / Revenue (See Note #1)		37,000.
Less: Cost of Goods Sold (16,250 – 2,000)		(14,250)
Gross Profit		22,750
Less: Admin. Expenses + Depreciation	12,500 + 400	(12,900)
Net Profit/ (Loss)		9,850

Balance sheet will look like this:

Saeed & Sons Balance Sheet			
As At January 31, 2002			
Liabilities		Assets	
Particulars	Amount Rs.	Particulars	Amount Rs.
Capital	150,000	Fixed Assets	
Add: Net Profit	9,850	Furniture Account	2,000
		Less: depreciation	(400)
	159,850		1,600
Current Liabilities		Current Assets	
Accrued Expenses	5,000	Cash	161,250
		Closing Stock	2,000
Total	164,850	Total	164,850

Treatment of depreciation is practically demonstrated at this point. Its journal entry will be discussed in detail, when we cover the topic 'Fixed Assets'.

Drawing

Capital is the cash or kind invested by the owner of the business. Sometimes, the owner wants to take cash or goods out of the business for personal use. This is known as **drawing**.

Any money taken out as drawings will reduce capital.

The capital account is very important account. To stop it getting full of small details, cash items of drawings are not entered in the capital account. Instead, a drawing account is opened, and all transactions are entered there.

Sometimes goods are also taken by the owner of the business. These are also known as drawings.

To understand the accounting treatment of drawings, look into the following trial balance:

Saeed & co.			
Trial Balance			
As on January 31, 2002			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	161,250	
Capital Account	02		160,000
Furniture Account	03	2,000	
Drawings	04	10,000	
Profit & loss account	05		8,250
Salim& co. (Creditor)	06		0
Usman & co. (Debtor)	07	0	
Accrued expenses	08		5,000
Total		173,250	173,250

Balance Sheet

Saeed & Sons			
Balance Sheet As At January 31, 2002			
Liabilities		Assets	
Particulars	Amount Rs.	Particulars	Amount Rs.
Capital	160,000	Fixed Assets	
Add: Net Profit	8,250	Furniture Account	2,000
Less: Drawings	(10,000)		
	158,250		
Current Liabilities	5,000	Current Assets	
Accrued Expenses		Cash	161,250
Total	163,250	Total	163,250

Lesson-13**VOUCHERS AND POSTING TO LEDGERS ACCOUNTS****Learning Objectives:**

After studying this lecture, you should be able to:

- Understand different types of vouchers.
- How to book entry in voucher?
- Carrying forward the balance of an account.

Voucher

In book keeping, voucher is the first document to record an entry. Vouchers are the documentary evidence of each financial transaction. Normally three types of vouchers are used:

- Receipt voucher
- Payment voucher
- Journal voucher

Receipt Voucher

Receipt voucher is used to record cash or bank receipt. Receipt vouchers are of two types:

- Cash receipt voucher
- Bank receipt voucher

Cash receipt voucher denotes receipt of cash. Bank receipt voucher indicates receipt of cheque or demand draft. Standard format of cash receipt voucher is given below:

Name of the Organization		
Bank Receipt / Cash Receipt OR Receipt Voucher		
Date: _____	No: _____	
Cash / Bank code: _____	Description / Title: _____	
Description / Title of Account	Code #	Credit Amount
Total:		
Narration:		
Prepared By:	Checked By:	

Payment Voucher

Payment voucher is used to record a payment of cash or cheque. Payment vouchers are of two types:

- Cash Payment voucher
- Bank Payment voucher

Cash Payment voucher denotes Payment of cash. Bank Payment voucher indicates payment by cheque or demand draft. Standard format of cash Payment voucher is given below:

Name of the Organization		
Bank Payment / Cash Payment OR Payment Voucher		
Date: _____	No: _____	
Cash / Bank code: _____	Description / Title: _____	
Description / Title of Account	Code #	Debit Amount
Total:		
Narration		
Prepared By:	Checked By:	

Journal Voucher

Journal voucher is used to record transactions that do not affect cash or bank. Standard format of journal voucher is given hereunder:

Name Of Organization			
Journal Voucher			
Date: _____	No: _____		
Description	Code #	Debit Amount	Credit Amount
Total:			
Narration:			
Prepared By:	Checked by:		

How to Carry Forward a Balance?

It is already mentioned that in 'T' account, at the end of accounting period, if one side is greater than the other side, balancing figure will be written on the lesser side as balance. For instance, if amount on debit side is greater than the amount on credit side, the balancing figure is written on the credit side as balance & it is known as **Debit Balance**. On the other hand, if amount on the credit side is greater than that of amount on the debit side, the balance is shown on the debit side. It is called the **Credit Balance**.

At the start of next accounting period, these balances are carried forward. Debit balance is written on the credit side, but it is the excess of debit side over the credit side, when it is carried forward, it is written on the debit side. For example, ledger account of cash is given below:

Cash Account				Account code # 1			
Date	Particulars	Code #	Dr. (Rs.)	Date	Particulars	Code #	Cr. (Rs.)
1-3-02	Capital a/c	02	150,000	5-3-02	Office furniture	03	2,000
13-3-02	Sales a/c	07	12,000	7-3-02	Purchases a/c	04	9,000
21-3-02	Received from debtors	08	25,000	10-3-02	Carriage a/c	05	250
				21-3-02	Paid to creditors	06	7,000
				23-3-02	Salaries a/c	09	2,500
				25-3-02	Rent a/c	10	3,000
				29-3-02	Stationery a/c	11	2,000
					Balance		161,250
	Total		187,000		Total		187,000

This cash account is showing the balance of Rs. 161,250 on the credit side. This balance is excess of debit side over the credit side and, therefore, is called the **debit balance**.

When it is **carried forward** it is written on the debit side because debit side of the cash account is greater & Rs. 161,250 is the balancing amount of the debit side of cash account. So, it is an asset & it will be used for further expenses in the forth coming period.

Let's take another example:

Accrued Expenses Account				Account code # 13			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31-3-02					Accrued bills	12	5,000
	Balance		5,000				
	Total		5,000		Total		5,000

In this account, balance is written on the debit side & it is called the credit balance. As this balance represents excess of credit side over debit side, when it is **carried forward** it is again written on the credit side.

It can also be explained like this:

- **Debit balance when carried forward, is written on the debit side**
- **Credit balance when carried forward, is written on the credit side**

This is further explained with the help of the following solved illustration:

Illustration

Following is the Trial Balance of Saeed & Sons for the month ended January 31, 2002

Saeed & Sons. Trial Balance As on January 31, 2002			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	55,000	
Accrued expense Account	02		10,000
Bank Account	03	25,000	
Loan Account	04		100,000
Furniture Account	05	20,000	
Office Equipment	06	10,000	
Total		110,000	110,000

In the month of February, following transactions took place:

No.	Date	Particulars
01	Feb 07	They purchased stationery worth of Rs. 5,000
02	Feb 10	They paid their first installment of loan Rs. 10,000
03	Feb 12	They received a cheque from a customer of Rs. 5,000
04	Feb 17	Accrued expenses of Rs. 5,000 are paid.
05	Feb 20	They purchased furniture of Rs. 1,000
06	Feb 23	Office equipment of Rs. 2,000 is sold
07	Feb 25	Staff salaries are paid by cheque Rs. 10,000
08	Feb 28	Sold goods for cash Rs.2,000

Solution: The ledger accounts of Saeed & Sons will bear the following changes:

Cash Account				Account code # 1			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
1-2-02	Balance c/f		55,000	7-2-02	Stationery	10	5,000
23-2-02	Office equipment.	06	2,000	10-2-02	Loan a/c	04	10,000
28-2-02	Sales a/c	01	2,000	17-2-02	Accrued expenses	02	5,000
					Furniture a/c	05	1,000
					Balance c/d		38,000
	Total		59,000		Total		59,000

Accrued Expenses				Account code # 2			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
17-2-02	Accrued expenses	01	5,000	1-1-02	Balance c/f		10,000
	Balance c/d		5,000				
	Total		10,000		Total		10,000

Bank Account				Account code # 3			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
17-2-02	Balance c/f	01	25,000	25-2-02	Salaries a/c		10,000
12-2-02	Cheque received	07	5,000		Balance c/d		20,000
	Total		30,000		Total		30,000

Loan Account				Account code # 4			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
10-2-02	Installment paid	01	10,000		Balance c/f		100,000
	Balance c/d		90,000				
	Total		100,000		Total		100,000

Furniture Account				Account code # 5			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
10-2-02	Balance c/f		20,000	23-2-02			
20-2-02	Furniture a/c	01	1,000		Balance c/d		21,000
	Total		21,000		Total		21,000

Office Equipment Account				Account code # 6			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
10-2-02	Balance c/f		10,000		Office Equipment	01	2,000
					Balance c/d		8,000
	Total		10,000		Total		10,000

Balance C/F is balance carried forward & **Balance C/D** is balance Carried down.

Lesson-14**POSTING TO LEDGERS AND RECORDING OF STOCK**

We have demonstrated the carrying forward of balances in lecture-13. Another solved example is given below:

Illustration

Following is the Trial Balance of Rahil & Co. for the month ended January 31, 2002.

Rahil & Co..			
Trial Balance			
As on January 31, 2002			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	30,000	
Accrued expense Account	02		10,000
Bank Account	03	50,000	
Loan Account	04		100,000
Furniture Account	05	20,000	
Office Equipment	06	10,000	
Debtors account	07	12,000	
Creditors account	08		10,000
Sales account	09		20,000
Purchase account	10	18,000	
Total		140,000	140,000

During the month, following entries took place:

No.	Date	Particulars
01	Feb 07	They purchased stationery worth of Rs. 3,000
02	Feb 10	They paid their first installment of loan Rs. 12,000
03	Feb 12	They received a cheque from a customer of Rs. 5,000
04	Feb 13	They paid a cheque of Rs. 8,000 to a creditor
05	Feb 15	Purchased goods of Rs 6,000 & paid through cheque
06	Feb 17	Accrued expenses of Rs. 5,000 are paid.
07	Feb 20	They purchased furniture of Rs. 2,000
08	Feb 21	Sold goods for cash Rs.5,000
09	Feb 22	Purchased goods on credit Rs. 5,000
10	Feb 23	Office equipment of Rs. 5,000 is Purchased
11	Feb 25	Staff salaries are paid by cheque Rs. 15,000
12	Feb 28	Utility expenses of Rs. 3,000 are accrued.

Ledger accounts of Rahil & Co. during the month will show following picture:

Cash Account				Account code # 1			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
1-2-02	Balance c/f	01	30,000	7-2-02	Stationery a/c	10	3,000
21-2-02	Sold a/c	09	5,000	10-2-02	Loan a/c	04	12,000
				17-2-02	Accrued expenses	02	5,000
					Furniture a/c	05	2,000
				23-2-02	Office equipment	06	5,000
					Balance c/d		8,000
	Total		35,000		Total		35,000

Accrued Expenses Account				Account code # 2			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
17-2-02	Accrued expenses	01	5,000	1-1-02	Balance c/f		10,000
	Balance c/d		8,000		Expenses accrued		3,000
	Total		13,000		Total		13,000

Bank Account				Account code # 3			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
12-2-02	Balance c/f		50,000	13-2-02	Paid to creditors	08	8,000
	Cheque received	07	5,000	15-2-02	Purchases	10	6,000
				25-2-02	Salaries a/c	11	15,000
					Balance c/d		26,000
	Total		55,000		Total		55,000

Loan Account				Account code # 4			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
10-2-02	Installment paid	01	12,000		Balance c/f		100,000
	Balance c/d		88,000				
	Total		100,000		Total		100,000

Furniture Account				Account code # 5			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
10-2-02	Balance c/f		20,000	23-2-02			
20-2-02	Furniture a/c	01	2,000		Balance c/d		22,000
	Total		22,000		Total		22,000

Office Equipment Account Account code # 6							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
23-2-02	Balance c/f Office Equipment a/c	01	10,000 5,000		Balance c/d		15,000
	Total		15,000		Total		15,000

Debtors Account Account code # 7							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
	Balance c/f		12,000	12-2-02	Cheque received	03	5,000
					Balance c/d		7,000
	Total		12,000		Total		12,000

Creditors Account Account code # 8							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
13-2-02	Paid to creditors	03	8,000	22-2-02	Balance c/f Purchases a/c	10	10,000 5,000
	Balance c/d		7,000				
	Total		15,000		Total		15,000

Sales Account Account code # 9							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
				21-2-02	Balance c/f Sales a/c	01	20,000 5,000
	Balance c/d		25,000				
	Total		25,000		Total		25,000

Purchases Account Account code # 10							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
15-2-02	Balance c/f Purchases a/c	03	18,000 6,000				
22-2-02	Purchases a/c	07	5,000		Balance c/d		29,000
	Total		29,000		Total		29,000

Salaries Account				Account code # 11			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
25-2-02	Salaries a/c	03	15,000				
					Balance c/d		15,000
	Total		15,000		Total		15,000

Stationery Account				Account code # 12			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
25-2-02	Stationery a/c	01	3,000				
					Balance c/d		3,000
	Total		3,000		Total		3,000

Utility Expenses Account				Account code # 13			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
28-2-02	Accrued utility expenses	02	3,000				
					Balance c/d		3,000
	Total		3,000		Total		3,000

The Trial Balance at the end of the month is as follows:

Rahil & Co.			
Trial Balance			
As on January 31, 2002			
Title of Account	Code	Dr. Rs.	Cr. Rs.
Cash Account	01	8,000	
Accrued expense Account	02		8,000
Bank Account	03	26,000	
Loan Account	04		88,000
Furniture Account	05	22,000	
Office Equipment	06	15,000	
Debtors account	07	7,000	
Creditors account	08		7,000
Sales account	09		25,000
Purchase account	10	29,000	
Salaries Account	11	15,000	
Stationery Account	12	3,000	
Utility Expenses Account	13	3,000	
Total		128,000	128,000

Difference between expenses & Purchases

- If business purchases items for its own use (items that are not meant to be resold) such items are charged to expense account.
- If business purchases items for resale purposes, such items are charged to purchases account.

Stock: Stock is the quantity of unsold goods lying with the organization.

Stock is termed as “the value of goods available to the business that are ready for sale”. For accounting purposes, stock is of two types:

1. In trading concern, Stock consists of goods that are purchased for the purpose of resale, but not sold in that accounting period. Trading concern is that organization, which purchases items for resale purposes.
2. In manufacturing concern, (an organization that converts raw material into finished product by putting it in a process) stock consists of:
 - Raw material
 - Work in process
 - Finished goods

Raw Material

Raw material is the basic part of an item, which is processed to make a complete item.

Work in Process

In manufacturing concern, raw material is put into process to convert it into finished goods. At the end of the year, some part of raw material remains under process. It is neither in shape of raw material nor in shape of finished goods. Such items are taken in stock as work in process.

Finished Goods

Finished goods contain items that are ready for sale, but could not be sold at the end of accounting period.

Recording of Stock Account

- Stock Account is **Debited** with the **Value of the Goods Purchased**
- Stock account is **credited** with the **Purchase Price of the Goods Sold / Issued for Production.**
- Stock Account shows the cost / purchase value of unsold goods.

In manufacturing concern, entries for stock are:

For Purchase of Stock

Debit:	Stock Account
Credit:	Cash/Supplier /Creditors Account

When the stock is purchased, stock account gets the benefit, so it is debited & cash or supplier account provides the benefit, so it is credited.

For Payment to Creditors

Debit:	Supplier / Creditors account
Credit:	Cash account

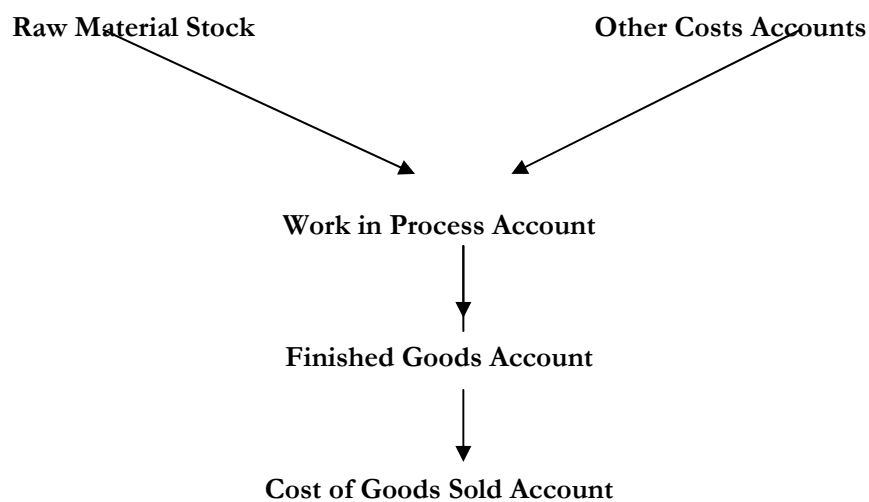
For Consumption of goods

Debit:	Cost of goods sold
Credit:	Stock Account

Cost of goods sold

Cost of goods sold is different in both forms of organizations:

- In trading concern, cost of goods sold is the value of goods unsold (goods stands for the items purchased for resale purpose)
- In manufacturing concern, cost of goods sold is the value of raw material consumed plus any other manufacturing cost. e.g., salaries of labor cost of machinery etc.

Stock and cost of goods sold in manufacturing concern

In manufacturing concern, Raw material stock is put into process. For accounting purposes, all value of stock and other manufacturing costs are charged to work in process account. When the process is completed and the goods are prepared, all the value of work in process is charged to finished goods account. The business sells finished goods for the whole accounting year. At the end of the year, goods that are unsold are deducted from cost of goods sold account.

Lesson-15**RECORDING OF STOCK (Continued)**

Stock is termed as “the value of goods available to the business that are ready for sale”. For accounting purposes, stock is of two types:

- Opening stock
- Closing stock

Opening stock is the value of goods available for sale in the beginning of an accounting period.

Closing stock is the value of goods unsold at the end of the accounting period.

Journal Entries to Record Stock**In Case of Trading Concern:**

Journal entries for those goods which are bought for resale purposes are as follows:

Purchase of goods:

Debit:	Stock/Material Account
Credit:	Cash/Bank/Creditor

Consumption of goods

Debit:	Cost of goods sold
Credit:	Stock

Payment in case of credit purchase

Debit:	Creditors Account
Credit:	Cash/Bank

In Case of Manufacturing Concern:

- In case of manufacturer there are at least two types of Stock Accounts:
 - Raw Material Stock Account
 - Finished Goods Stock Account

Raw Material

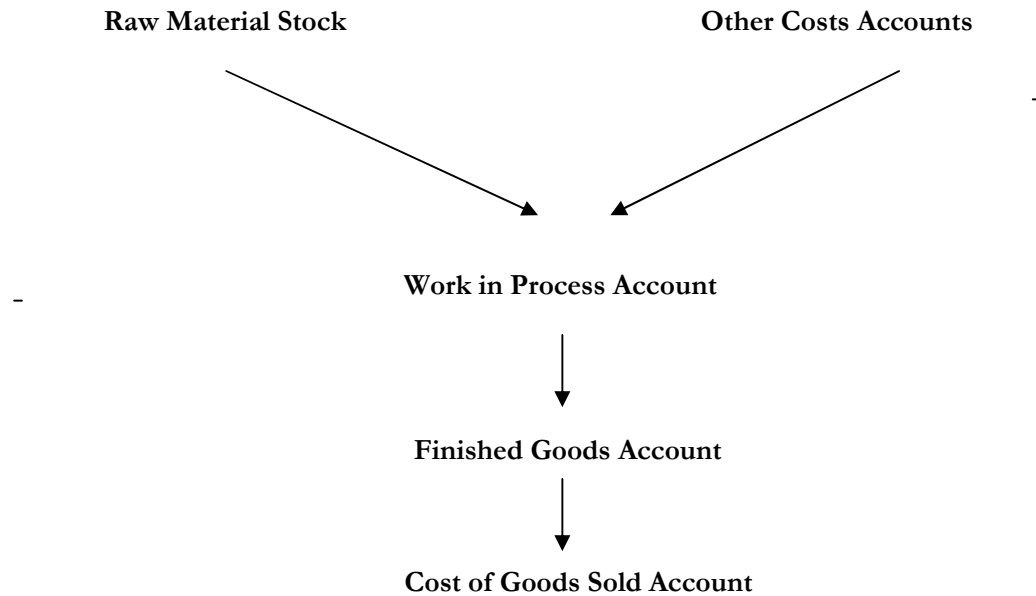
Raw material is the basic part of an item, which is processed to make a complete item

Finished Goods

Finished goods contain the items that are ready for sale, but could not be sold in that accounting period.

Work in Process

In manufacturing concern, raw material is put in a process to convert it into finished goods. At the end of accounting period, some part of raw material remains under process. i.e. it is neither in shape of raw material nor in shape of finished goods. Such items are taken in stock as work in process.

Flow of Costs

In manufacturing concern, Raw material stock is put into process. For accounting purposes, all value of stock and other manufacturing costs are charged to work in process account. When the process is completed and the goods are prepared, all the value of work in process is charged to finished goods account. The business sells finished goods for the whole accounting year. At the end of the year, goods that are unsold are deducted from cost of goods sold account.

Journal Entries**For Manufacturing Concern**

Purchase of raw material

Debit: Stock/Material Account
Credit: Cash/Bank/Creditors

Other direct costs incurred

Debit: Relevant cost/Expense Head
Credit: Cash/Bank/Payables

Raw material issued and other costs allocated to production of units

Debit: Work in process
Credit: Stock Material Account

Debit: Work in process
Credit: Relevant Expense Head Account

When production is completed

Debit: Finished Goods Stock Account
Credit: Work in process account

Entry for Cost of sale

Debit:	Cost of Goods Sold Account
Credit:	Finished Goods Stock Account

Entry for sale of goods

Debit:	Cash/Account receivable Account
Credit:	Sales Account

Return of material purchased

There are two options for recording purchase material return

- **Option 1**

Debit:	Goods Return Account
Credit:	Stock Material Account

AND

Debit:	Cash/Bank Account
Credit:	Goods Return Account

OR

If our supplier suppliers use some other material in exchange of material returned. Then:

Debit	Raw Material Stock Account
Credit:	Goods Return Account

In the first case above, cash is received in return of goods. In the second case, defective goods are exchanged with quality goods. That is why, we debited our stock account. Both entries are correct for return of purchased items.

- **Option 2**

Debit:	Cash/Creditor Account
Credit:	Stock Account

Example 1

Record the following transactions:

1. Purchased goods for cash Rs. 10,000
2. Purchased goods on credit from ABC Co. Rs. 25,000
3. Sold goods which cost was Rs. 20,000
4. Returned goods to ABC Co. that originally cost Rs. 5,000
5. Paid to ABC Co. Rs. 15,000 through cheque
6. Sold goods whose cost was Rs. 5,000

Required:

1. Cost of goods sold
2. Value of closing stock
3. Amount payable to ABC Co.

1 – Purchased goods for cash Rs. 10,000

Cash Account Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	1	Purchased goods for cash		10,000	(10,000)

Stock Account Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	1	Purchased goods for cash	10,000		10,000

2 – Purchased goods on credit from ABC Co. Rs. 25,000

ABC Co. Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	2	Purchased goods from ABC		25,000	(25,000)

Stock Account Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	1	Purchased goods for cash	10,000		10,000
	2	Purchased goods from ABC	25,000		35,000

3 – Sold goods whose cost was Rs. 20,000

Cost of Goods Sold Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	3	Goods sold	20,000		20,000

Stock Account Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	1	Purchased goods for cash	10,000		10,000
	2	Purchased goods from ABC	25,000		35,000
	3	Goods sold		20,000	15,000

4 – Returned goods to ABC Co. cost Rs. 5,000

ABC Co. Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	2	Purchased goods from ABC		25,000	(25,000)
	4	Returned goods to ABC	5,000		(20,000)

Stock Account Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	1	Purchased goods for cash	10,000		10,000
	2	Purchased goods from ABC	25,000		35,000
	3	Goods sold		20,000	15,000
	4	Returned goods to ABC		5,000	10,000

5 – Paid to ABC Co. Rs. 15,000 through cheque

ABC Co. Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	2	Purchased goods from ABC		25,000	(25,000)
	4	Returned goods to ABC	5,000		(20,000)
	5	Paid to ABC	15,000		(5,000)

Bank Account Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	5	Paid to ABC		15,000	

6 – Sold goods whose cost was Rs. 5,000

Cost of Goods Sold Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	3	Goods sold	20,000		20,000
	6	Goods sold	5,000		25,000

Stock Account Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	1	Purchased goods for cash	10,000		10,000
	2	Purchased goods from ABC	25,000		35,000
	3	Goods sold		20,000	15,000
	4	Returned goods to ABC		5,000	10,000
	6	Goods sold		5,000	5,000

Cost of Goods Sold

Cost of Goods Sold Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	3	Goods sold	20,000		20,000
	6	Goods sold	5,000		25,000

Value of Closing Stock

Stock Account Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	1	Purchased goods for cash	10,000		10,000
	2	Purchased goods from ABC	25,000		35,000
	3	Goods sold		20,000	15,000
	4	Returned goods to ABC		5,000	10,000
	6	Goods sold		5,000	5,000

Amount Payable to ABC Co.

ABC Co. Code --					
Date	No.	Narration	Dr. Rs.	Cr. Rs.	Bal. Dr/(Cr)
	2	Purchased goods from ABC		25,000	(25,000)
	4	Returned goods to ABC	5,000		(20,000)
	5	Paid to ABC	15,000		(5,000)

Example 2

Using the following data calculate the Cost of Goods Sold of XYZ Co.

■ Stock levels	Opening Rs.	Closing Rs.
Raw material	100,000	85,000
Work in process	90,000	95,000
Finished goods	150,000	140,000
■ Purchase of raw material during the period	Rs. 200,000	
■ Paid to labor	Rs. 180,000 out of which Rs. 150,000 used on production.	
■ Other production costs	Rs. 50,000	

Raw Material Account			
O/S	100,000		
Purchases	200,000	WIP	215,000
		C/S	85,000
Total	300,000	Total	300,000

Labor Account			
Cost	180,000	Charge	150,000
Total	180,000	Total	180,000

Other Costs Account			
Paid	50,000	Charge	50,000
Total	50,000	Total	50,000

Work in Process Account			
O/B	90,000		
Raw M	215,000		
Labor	150,000	F/G	410,000
O/H	50,000	C/B	95,000
Total	505,000	Total	505,000

Finished Goods Stock Account			
O/S	150,000	COS	420,000
WIP	410,000	C/S	140,000
Total	560,000	Total	460,000

Cost of goods sold			
F/G	420,000		

Illustration # 1

Record the following transactions

- Purchased goods for cash Rs, 10,000
- Purchased goods from Ali Brothers. worth of Rs. 20,000
- Sold goods having cost of Rs.15,000
- Returned goods to Ali Brothers. worth of Rs. 4,000
- Sold goods having cost of Rs. 5,000
- Paid to Ali Brothers. Rs. 10,000.

Also ascertain

- Cost of goods sold.
- Value of closing stock.
- Payable to Ali Brothers.

Solution

First, we will pass journal entries

Particulars	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Stock Account	10,000	
Cash Account		10,000
Goods purchased for cash		

Particulars	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Stock Account	20,000	
Ali Brothers.		20,000
Goods purchased from Ali Brothers.		

Particulars	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Cost of goods sold	15,000	
Stock Account		15,000
Goods sold whose cost was Rs. 15,000		

Particulars	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Ali Brothers.	4,000	
Stock Account		4,000
Goods returned to Ali Brothers.		

Particulars	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Cost of goods sold	5,000	
Stock Account		5,000
Goods sold whose cost was Rs. 5,000		

Particulars	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Ali Brothers. Account	10,000	
Cash Account		10,000
Paid to Ali Brothers.		

Payable to Ali Brothers

Ali Brothers Account							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
	Goods returned		4,000		Purchased goods		20,000
	Paid cash		10,000				
	Balance		6,000				
	Total		20,000		Total		20,000

Cost of Goods Sold

Cost of goods sold Account							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
	Goods sold		15,000				
	Goods sold		5,000				
					Balance		20,000
	Total		20,000		Total		20,000

Value of Closing Stock

Stock Account							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
	Purchased goods for cash		10,000		Goods sold		15,000
	Purchased goods from Ali Brothers.		20,000		Returned to Ali Brothers		4,000
					Goods sold		5,000
					Balance		6,000
	Total		30,000		Total		30,000

Illustration # 2

Using the following data calculate the Cost of Goods Sold of XYZ Co.

Stock levels	Opening Rs.	Closing Rs.
Raw material	100,000	85,000
Work in process	90,000	95,000
Finished goods	150,000	140,000

- Purchase of raw material during the period Rs. 200,000
- Paid to labor Rs. 180,000 out of which Rs. 150,000 used on production.
- Other production costs Rs. 50,000

Labor cost of Rs. 180,000 is given, out of which Rs. 150,000 is charged to production. (Remaining cost of Rs. 30,000 will be explained in some later stage). That means Rs. 150,000 is charged to work in process OR WIP account through the following entry:

Debit:	Work in process OR WIP Account
Credit:	Labor Cost Account

Other costs of Rs. 50,000 are also charged to work in process OR WIP account through the following entry:

Debit:	Work in process OR WIP Account
Credit:	Other Costs Account

Work in process account has the opening balance of Rs. 90,000 and closing balance of Rs. 95,000. After charging all the above mentioned accounts to WIP, balancing figure of work in process of Rs. 410,000 is charged to finished goods account through the following entry:

Debit:	Finished Goods Account
Credit:	Work in process Account

Finished goods account has the opening balance of Rs. 150,000 and closing balance of Rs. 140,000. After charging WIP account to finished goods, the balancing figure of Rs. 420,000, is charged to cost of goods sold account through the following entry:

Debit:	Cost of Goods Sold Account
Credit:	Finished Goods Account

Lesson-16**COST OF GOODS SOLD STATEMENT AND VALUATION OF STOCK**

In manufacturing concern, separate books are maintained to keep the record of every single work done in manufacturing process to ascertain cost incurred on production of goods. This record gives information about total cost incurred on manufacturing process and per unit cost of goods manufactured. When goods are produced, these are sold to the customers of the business and goods unsold are taken into stock. At the end of the financial year, manufacturing concern prepares a statement which gives the brief summary of the whole process.

This statement shows the value of raw material consumed, amount spent on labor and other factory expenses, finished goods produced and goods unsold (in stock). Such statement is called '**cost of goods sold statement**'. Manufacturing concerns, while presenting financial statements, also present cost of goods sold statement.

Standard format of cost of goods sold statement is given below:

Raw Material:	O/S Raw Material + Purchases + Cost Incurred to Purchase RM - C/S Raw Material Cost of Material Consumed
Conversion Cost:	+ Direct Labor Cost + Factory Overheads Total Factory Cost
Work in Process	+ O/S of WIP - C/S of WIP Cost of Goods Manufactured
Finished Goods	+ O/S of Finished Goods - C/S of Finished Goods Cost of Good Sold

Cost of material consumed – is the cost of material used for consumption that has been put in the production process. This head shows the raw material left unused from the previous year (opening stock), raw material purchased in the current year, expenses incurred in bringing the purchased material into the business premises and raw material that is not used in the current year (closing stock).

Over Heads Costs----are the other costs incurred in relation of manufacturing of goods.

Examples are factory utilities, supervisor salaries, equipment repairs etc.

Total factory cost – is the cost of material consumed plus labor and over heads. In other words it is the total cost incurred in the factory.

Cost of goods manufactured – is total factory cost plus opening stock of work in process less closing stock of work in process.

Cost of goods sold – is the cost of goods manufactured plus opening stock of finished goods less closing stock of finished goods.

Prime/Basic Cost = Cost of Direct Material Consumed + Direct Labor cost

Conversion cost it is the cost incurred to convert raw material to finished goods.

Conversion cost = Labor cost + factory overhead

Example

Using the following data calculate the Cost of Goods Sold of XYZ Co.

■ Stock levels	O/S Rs.	C/S Rs.
Raw material	100,000	85,000
Work in process	90,000	95,000
Finished goods	150,000	140,000
■ Purchase of raw material during the period	Rs. 200,000	
■ Paid to labor	Rs. 180,000 out of which Rs. 150,000 used on production.	
■ Other production costs	Rs. 50,000	

Solution

XYZ Co.
Cost of Goods Sols Statement
For the period ended-----

Raw Material:	Opening Stock Raw Material	100,000	
	+ Purchases	200,000	
	+ Cost Incurred to Purchase RM	0	
	- Closing Stock Raw Material	<u>(85,000)</u>	
	Cost of Material Consumed		215,000
Conversion Cost	+ Labor Cost	150,000	
	+Factory overhead	<u>50,000</u>	
			<u>200,000</u>
Total Factory Costs			415,000
Work in process	+ O/S of WIP	90000	
	- C/S of WIP	<u>(95000)</u>	
Cost of Goods Manufactured			410,000
Finished Goods	+ O/S of Finished Goods	150,000	
	- C/S of Finished Goods	<u>(140,000)</u>	
Cost of Goods Sold			<u>420,000</u>

Illustration

Following information of Ahmad & Company is given. Prepare a cost of goods sold statement.

■ Stock levels	O/S Rs.	C/S Rs.
Raw material	150,000	115,000
Work in process	50,000	55,000
Finished goods	120,000	100,000
■ Purchase of raw material during the period	Rs. 100,000	
■ Transportation charges of items purchased	Rs. 5,000	
■ Paid to labor	Rs. 100,000.	
■ Other production costs(FOH)	Rs. 80,000	

Solution

Raw Material:	Opening Stock Raw Material	150,000
	+ Purchases	100,000
	+ Cost Incurred to Purchase RM	5,000
	- Closing Stock Raw Material	<u>(115,000)</u>

	Cost of Material Consumed	140,000
Conversion Cost:	+ Labor	100,000
	+ Factory Overheads	<u>80,000</u>
	Total Factory Cost	320,000
Work in Process:	+ O/S of WIP	50,000
	- C/S of WIP	<u>(55,000)</u>
	Cost of Goods Manufactured	315,000
Finished Goods:	+ O/S of Finished Goods	120,000
	- C/S of Finished Goods	<u>(100,000)</u>
	Cost of Good Sold	<u>335,000</u>

Stock Card

Stock card is used to keep the record of what has come in stock and what has gone out of it. Standard format of stock card is given below:

Stock Account Item 01									
Date	Receipts	Qty	Rate	Amount	Date	Issues	Qty	Rate	Amount

Stock card has two parts:

- Receipt side
- Issue side

Both sides have similar columns that include:

- Nature of item to be kept in stock
- Quantity of items
- Rate at which it was purchased
- Total value of items

Receipt side is used to record data of items coming in the stock and issue side is used to record information of goods issued for manufacturing process.

Valuation of Stock

Any manufacturing organization purchases different material through out the year. The prices of purchases may be different due to inflationary conditions of the economy. The question is, what item should be issued first & what item should be issued later for manufacturing. For this purpose, the organization has to make a policy for issue of stock. All the issues for manufacturing and valuation of stock are recorded according to the policy of the organization. Mostly these three methods are used for the valuation of stock:

Methods of Stock valuation

- First in first out (FIFO)
- Last in first out (LIFO)
- Weighted average

First in first out (FIFO)

The FIFO method is based on the assumption that the first merchandise purchased is the first merchandised issued. The FIFO uses actual purchase cost. Thus, if merchandise has been purchased at several different costs, the inventory (stock) will have several different cost prices. The cost of goods sold for a given sales transaction may involve several different cost prices.

Characteristics

- This is widely used method for determining values of cost of goods sold and closing stock.
- In the FIFO method, oldest available purchase costs are transferred to cost of goods sold. That means the cost of goods sold has a lower value and the profitability of the organization becomes higher.
- As the current stock is valued at recent most prices, the current assets of the company have the latest assessed values.

Last in first out (LIFO)

As the name suggests, the LIFO method is based on the assumption that the recently purchased merchandise is issued first. The LIFO uses actual purchase cost. Thus, if merchandise has been purchased at several different costs, the inventory (stock) will have several different cost prices. The cost of goods sold for a given sales transaction may involve several different cost prices.

Characteristics

- This is alternatively used method for determining values of cost of goods sold and closing stock.
- In the LIFO method recent available purchase costs are transferred to cost of goods sold. That means the cost of goods sold has a higher value and the profitability of the organization becomes lower.
- As the current stock is valued at oldest prices, the current assets of the company have the oldest assessed values.

Weighted average method

When weighted average method is in use, the average cost of all units in inventory, is computed after every purchase. This average cost is computed by dividing the total cost of goods available for sale by the number of units in inventory. Under the average cost assumption, all items in inventory are assigned the same per unit cost. Hence, it does not matter which units are sold; the cost of goods sold is always based on current average unit cost.

Characteristics

- Under the average cost assumption, all items in inventory are assigned same per unit cost (the average cost). Hence it does not matter which units are sold first. The cost of goods sold is always on the current average unit cost.
- Since all inventories are assigned same cost, this method does not make any effect on the profitability and does not increase/decrease any asset in the financial statements.
- This is the alternatively used method for determining values of cost of goods sold and closing stock.

Example

Receipts:

- 01 Jan 20--, 10 units @ Rs. 150 per unit
- 02 Jan 20--, 15 units @ Rs. 200 per unit
- 10 Jan 20--, 20 units @ Rs. 210 per unit

Issues:

- 05 Jan 20--, 05 units
- 06 Jan 20--, 10 units
- 15 Jan 20--, 15 units

FIFO Method of Stock Valuation

Date	Receipts	Issues	Value of Stock
01-01-20--	10 @ Rs. 150 = 1,500		10 x 150 = 1500
02-01-20--	15 @ Rs. 200 = 3,000		10 x 150 = 1500 15 x 200 = 3000 4500
05-01-20--		5 @ 150 = 750 750	5 x 150 = 750 15 x 200 = 3000 3750
06-01-20--		5 @ 150 = 750 5 @ 200 = 1000 1750	0 x 150 = 0 10 x 200 = 2000 2000
10-01-20--	20 @ Rs. 210 = 4200		10 x 200 = 2000 20 x 210 = 4200 6200
15-01-20--		10 @ 200 = 2000 5 @ 210 = 1050 3050	0 x 200 = 0 15 x 210 = 3150 3150

Weighted Average Method of Stock Valuation

Date	Receipts	Issues	Value of Stock	Average Cost
01-01-20--	10x150 = 1500		1500	1500/10=150
02-01-20--	15x200 = 3000		1500 + 3000 = 4500	4500/25=180
05-01-20--		5x180 = 900	4500 – 900 = 3600	3600/20=180
06-01-20--		10x180 = 1800	3600 – 1800 = 1800	1800/10=180
10-01-20--	20x210 = 4200		1800 + 4200 = 6000	6000/30=200
15-01-20--		15x200 = 3000	6000 – 3000 = 3000	3000/15=200

Effects of valuation method on profit**FIFO Method**

- Cost of Sales = 750 + 1750 + 3050 = 5,550
- Gross Profit = 7500 – 5550 = 1,950

Weighted Average Method

- Cost of Sales = 900 + 1800 + 3000 = 5,700
- Gross Profit = 7500 – 5700 = 1,300

NOTE: Rs. 7,500 is assumed value.

Illustration

Hamid & company is a manufacturing concern. Following is the receipts & issues record for the month of May, 2002

Date	Receipts	Issues
May 7	200 units @ Rs. 50/unit	
May 9		60 units
May 13	150 units @ Rs. 75/unit	
May 18	100 units @ Rs. 60/unit	
May 22		150 units
May 24		100 units
May 27	100 units @ Rs. 50/unit	

May 30

200 units

Calculate the value of closing stock by

- FIFO Method
- Average Method

Solution**Valuation of Stock by FIFO Method**

Date	Receipts	Issues	Value of Stock	Total Amount	Remaining No. of units	Net Balance
May 7	200 units @ Rs. 50/unit		200 x 50 = 10,000	10,000	200	10,000
May 9		60 units @ Rs. 50/unit	60 x 50 = 3,000	(3,000)	140	7,000
May 13	150 units @ Rs. 75/unit		75 x 150 = 11,250	11,250	290	18,250
May 18	100 units @ Rs. 60/unit		60 x 100 = 6,000	6,000	390	24,250
May 22		140 units @ Rs. 50/unit 10 units @ Rs. 75/unit	50 x 140 = 7,000 10 x 75 = 750	(7,750)	240	16,500
May 24		100 units @ Rs. 75/unit	75 x 100 =7,500	(7,500)	140	9,000
May 27	100 units @ Rs. 50/unit		50 x 100 = 5,000	5,000	240	14,000
May 30		40 units @ Rs. 75/unit 100 units @ Rs. 60/unit 60 units @ Rs. 50/unit	75 x 40 = 3,000 60 x 100 = 6,000 50 x 60 = 3,000	(12,000)	40	2,000

Valuation of Stock by Weighted Average Method:

Date	Receipts	Issues	Value of Stock	Total Amount(Rs.)	Total Units	Average Cost(Rs.)/unit	Net Balance (Rs.)
May 7	200 units @ Rs. 50/unit		200 x 50 = 10,000	10,000	200	50	10,000
May 9		60 units	60 x 50 = 3,000	(3,000)	140		7,000
May 13	150 units @ Rs. 75/unit		150 x 75 = 11,250	7,000+11250 = 18250	140+150 = 290	18250/290 = 62.9	18,250
May 18	100 units @ Rs. 60/unit		100 x 60 = 6,000	18250+6000 = 24250	290+100 = 390	24250/390 = 62.2	24,250
May 22		150 units	150 x 62.2 = 9330	(9,330)	390-150 = 240		14,920
May 24		100 units	100 x 62.2 = 6220	(6,220)	240-100 = 140		8,700
May 27	100 units @ Rs. 50/unit		100 x 50 = 5,000	8,700+5,000 = 13,700	140+100 = 240	13700/240 = 57.1	13,700
May 30		200 units	200 x 57.1 = 11,420	(11,420)	240-200 = 40		2,280

Lesson-17**FIXED ASSETS & DEPRECIATION**

Depreciation is a systematic allocation of the cost of a depreciable asset to expense over its useful life. It is a process of charging the cost of fixed asset to profit & loss account.

Fixed Assets are those assets which are:

- Of long life
- To be used in the business to generate revenue
- Not bought with the main purpose of resale.

Fixed assets are also called “Depreciable Assets”

When an expense is incurred, it is charged to profit & loss account of the same accounting period in which it has incurred. Fixed assets are used for longer period of time. Now, the question is how to charge a fixed asset to profit & loss account. For this purpose, estimated life of the asset is determined. Estimated useful life is the number of years in which a fixed asset is expected to be used efficiently. It is the life for which a machine is estimated to provide more benefit than the cost to run it. Then, total cost of the asset is divided by total number of estimated years. The value, so determined, is called ‘depreciation for the year’ and is charged to profit & loss account. The same amount is deducted from total cost of fixed asset in the financial year in which depreciation is charged. The net amount (after deducting depreciation) is called ‘Written down Value’.

$$\text{WDV} = \text{Original cost of fixed asset} - \text{Accumulated Depreciation}$$

Accumulated Depreciation is the depreciation that has been charged on a particular asset from the time of purchase of the asset to the present time. This is the amount that has been charged to profit and loss account from the year of purchase to the present year.

Depreciation accumulated over the years is called **accumulated depreciation**.

Useful Life

- Useful Life or Economic Life is the time period for machine is expected to operate efficiently.
- It is the life for which a machine is estimated to provide more benefit than the cost to run it.

Grouping of Fixed Assets

Major groups of Fixed Assets:

- Land
- Building
- Plant and Machinery
- Furniture and Fixtures
- Office Equipment
- Vehicles

No depreciation is charged for ‘Land’. In case of ‘Leased Asset/Lease Hold Land’ the amount paid for it is charged over the life of the lease and is called **Amortization**.

Journal entries for recording Depreciation

Purchase of fixed asset:

Debit: Relevant asset account
Credit: Cash, Bank or Payable Account

For recording of depreciation, following two heads of accounts are used:

- Depreciation Expense Account
- Accumulated Depreciation Account

Depreciation expense account contains the depreciation of the current year. Accumulated depreciation contains the depreciation of the asset from the financial year in which it was bought up to the present financial year. . Depreciation of the following years in which asset was used is added up in this account. In other words, this head of account shows the cost of usage of the asset up to the current year. Depreciation account is charged to profit & loss account under the heading of Administrative Expenses. In the balance sheet, fixed assets are presented at written down value i.e.

$$\text{WDV} = \text{Actual cost of fixed asset} - \text{Accumulated Depreciation.}$$

Journal entry for the depreciation is given below:

Debit: Depreciation Expenses Account
Credit: Accumulated Depreciation Account

Presentation of Depreciation

Charging depreciation to any head in profit & loss account depends upon the nature of work performed by the asset. Consider an organization has purchased computers. If computers are being used by the management, this means that administrative work is done by computers. So, depreciation of computers will be charged to Administrative Expenses. On the other hand, if machines working in the factory are computerized. The value of depreciation of the computers attached with the machines will be charged to cost of goods sold. The reason being, the computers are the part of manufacturing process & depreciation of computers will be charged to the cost of production. Again consider the selling department of the business is very large. Depreciation of computers used in selling department will be charged to selling expenses.

You can see that computer is a single asset and its depreciation is charged in three different heads depending upon the nature of work done by the computer.

Depreciation for the year is charged to:

- Cost of Goods Sold
- Administrative Expenses
- Selling Expenses

In balance sheet Fixed Assets are shown at Cost less Accumulated Depreciation i.e. written Down Value (WDV).

Methods of calculating Depreciation

There are several methods for calculating depreciation. At this stage, we will discuss only two of them namely:

- Straight line method or Original cost method or Fixed installment method
- Reducing balance method or Diminishing balance method or written down method.

Straight Line Method

Under this method, a fixed amount is calculated by a formula. That fixed amount is charged every year irrespective of the written down value of the asset. The formula for calculating the depreciation is given below:

$$\text{Depreciation} = (\text{cost} - \text{Residual value}) / \text{Expected useful life of the asset}$$

Residual value is the cost of the asset after the expiry of its useful life.

Under this method, at the expiry of asset's useful life, its written down value will become zero. Consider the following example:

- Cost of the Asset = Rs.100,000
- Life of the Asset = 5 years
- Annual Depreciation = 20 % of cost or Rs.20,000

Written down value method

- Cost of the Asset = Rs. 100,000
- Annual Depreciation = 20%
 - Year 1 Depreciation = 20 % of 100,000 = 20,000
 - Year 1 WDV = 100,000 – 20,000 = 80,000
 - Year 2 Depreciation = 20 % of 80,000 = 16,000
 - Year 2 WDV = 80,000 – 16,000 = 64,000

Illustration:

Cost of an asset: Rs. 120,000

Residual value: Rs. 20,000

Expected life: Rs. 5 years

Calculate depreciation and the written down value of the asset for five years.

Solution**Straight line method**

$$\text{Depreciation} = (120,000 - 20,000) / 5 = \text{Rs. } 20,000$$

Particulars	Depreciation (Rs)	Written Down Value (Rs.)
Depreciable cost		100,000
Dep. Of the 1 st year	(20,000)	80,000
Dep. Of the 2 nd year	(20,000)	60,000
Dep. Of the 3 rd year	(20,000)	40,000
Dep. Of the 4 th year	(20,000)	20,000
Dep. Of the 5 th year	(20,000)	0

Reducing Balance Method

Under this method, depreciation is calculated on written down value. In the first year, depreciation is calculated on cost. Afterwards written down value is calculated by deducting accumulated depreciation from the cost of that asset (cost – accumulated depreciation) and depreciation is charged on that value. In this method, the value of asset never becomes zero. Consider the following example:

Cost of an asset Rs. 100,000

Expected life Rs. 5 years

Depreciation rate 20%

Solution

Particulars	Depreciation (Rs)	Accumulated Depreciation (Rs.)	Written Down Value (Rs.)
Depreciable cost			100,000
Dep. Of the 1 st year 100,000 x 20%	20,000	20,000	80,000
Dep. Of the 2 nd year 80,000 x 20%	16,000	36,000	64,000
Dep. Of the 3 rd year 64,000 x 20%	12,800	48,800	51,200
Dep. Of the 4 th year 51,200 x 20%	10,240	59,040	40,960
Dep. Of the 5 th year 40,960 x 20%	8,192	67,232	32,768

You see, at the end of five years, WDV of the asset is Rs. 32,768, not zero. But in case of straight line method, the WDV, after five years was zero. So, in the opinion of some people, reducing balance method is better than that of straight line method, but both methods are effective. It is the management that has to decide, which method is best suited to their business.

Once an asset has been fully depreciated, no more depreciation should be recorded on it, even though the property may be in good condition and may be in use. The objective of depreciation is to spread the cost of an asset over the periods of its usefulness; in no case can depreciation be greater than the amount paid for the asset. When a fully depreciated asset is in use beyond the original estimate of useful life, the asset account and the accumulated depreciation account should remain in the accounting records without further entries until the asset is retired.

Lesson-18**METHODS OF CHARGING DEPRECIATION (Continued)**

It is a systematic allocation of the cost of a depreciable asset to expense over its useful life”.

Grouping of Fixed Assets

Major groups of Fixed Assets:

- Land
- Building
- Plant and Machinery
- Furniture and Fixtures
- Office Equipment
- Vehicles

No depreciation is charged for ‘Land’. In case of ‘Leased Asset/Lease Hold Land’ the amount paid for it is charged over the life of the lease and is called **Amortization**.

Recording of Journal Entries

Purchase of fixed asset:

Debit:	Relevant asset account
Credit:	Cash, Bank or Payable Account

For recording of depreciation, following two heads of accounts are used:

- Depreciation Expense Account
- Accumulated Depreciation Account

Depreciation expense account contains the depreciation of the current year. Accumulated depreciation contains the depreciation of the asset from the financial year in which it was bought. Depreciation of the following years in which asset was used is added up in this account. In other words, this head of account shows the cost of usage of the asset up to the current year. Depreciation account is charged to profit & loss account under the heading of Administrative Expenses. In the balance sheet, fixed assets are presented at written down value i.e.

$$\text{WDV} = \text{Actual cost of fixed asset} - \text{Accumulated Depreciation.}$$

Journal entry for the depreciation is given below:

Debit:	Depreciation Account
Credit:	Accumulated Depreciation Account

Methods of Calculating Depreciation

There are several methods of calculating depreciation. At this stage, we will discuss only two of them namely:

- Straight line method
- Reducing balance method

Straight Line Method

In this method, a fixed amount is calculated by a formula. That fixed amount is charged every year irrespective of the written down value of the asset. The formula for calculating the depreciation is given below:

$$\text{Depreciation} = (\text{cost} - \text{Residual value}) / \text{Expected useful life of the asset}$$

Residual value is the cost of the asset after the expiry of its useful life.

Reducing Balance Method

In this method, depreciation is calculated on written down value. In the first year, depreciation is calculated on cost. Afterwards written down value is calculated by deducting accumulated depreciation from the cost of that asset (cost – accumulated depreciation) and depreciation is charged on that value.

Cost of Asset – Price at which the asset was initially recorded

Written Down Value / Book Value – Cost minus Accumulated Depreciation.

In **reducing balance method**, a formula is used for calculation the depreciation rate i.e.

$$\text{Rate} = 1 - \sqrt[n]{\text{RV} / \text{C}}$$

Where:

“RV” = Residual Value

“C” = Cost

“n” = Life of Asset

Calculate the rate if:

Cost	= 100,000
Residual Value (RV)	= 20,000
Life	= 3 years

$$\begin{aligned} \text{Rate} &= 1 - \sqrt[3]{20000/100000} \\ &= 42\% \end{aligned}$$

Year 1

Cost	100,000
Depreciation 100,000 x 42%	<u>(42,000)</u>
WDV (Closing Balance)	58,000

Year 2

WDV (Opening Balance)	58,000
Depreciation 58,000 x 42%	<u>(24,360)</u>
WDV (Closing Balance)	33,640

Year 3

WDV (Opening Balance)	33,640
Depreciation 33,640 x 42%	<u>(14,128)</u>
WDV (Closing Balance)	19,511

Disposal of Asset

Cost of Asset	= 100,000
Life of the Asset	= 5 Years
Depreciation Method	= Straight Line
Residual Value	= Rs.10000
Sale Price after Five Years	= Rs.15000

$$\begin{aligned} \text{Depreciation per year} &= (100000-10000) / 5 \\ &= \text{Rs. } 18,000 \text{ per year} \end{aligned}$$

Total Depreciation in Five Years	= 18,000 x 5 = 90,000
Book Value after Five Years	= 100,000- 90,000 = 10,000
Profit on Disposal	= 15,000 – 10,000 = Rs.5000

Recording of Disposal

Debit	Fixed Asset Disposal A/c	100,000	
Credit	Fixed Asset Cost A/c		100,000
	(With the cost of asset)		
Debit	Accumulated Dep. A/c	90,000	
Credit	Fixed Asset Disposal A/c		90,000
	(With the depreciation accumulated to date)		
Debit	Cash / Bank / Receivable A/c	15,000	
Credit	Fixed Asset Disposal A/c		15,000
	(With the price at which asset is sold)		

[Note: one group to appear at a time]

Disposal of Asset Account

Fixed Asset Disposal Account			
Debit		Credit	
Cost Account	100,000	Acc. Dep. Account	90,000
		Cash / Bank	15,000
P & L Account (Balancing Figure)	5000		
Total	105000	Total	105000

Policy for Depreciation

The management of the business selects the policy for charging depreciation. There is no law binding on the management. The management is free to choose method of depreciation and policy of charging depreciation. Normally two policies are commonly used:

- Depreciation on the basis of use
- In the year of purchase, full year's depreciation is charged; where as, in the year of sale no depreciation is charged.

Now it is up to the management to decide, what method and what policy is better and effective for their business.

Disposal of Fixed Asset

When depreciable asset is disposed off at any time during the financial year, an entry should be made to give effect of the disposal. Since, the residual value of asset is only estimated; it is common for asset to be sold at price that differs from its book value at the date of disposal. When asset is sold, any profit or loss is computed by comparing book value with the amount received from sale. As you know, book value is obtained by deducting accumulated depreciation from original cost of the asset. A sale price in excess of the book value produces profit; a sale price below the book value produces loss. This profit or loss should be shown in the profit & loss account.

Entries for Recording Disposal

Debit	Fixed Asset Disposal A/c
Credit	Fixed Asset Cost A/c (With the cost of asset)

Debit Accumulated Dep. A/c
Credit Fixed Asset Disposal A/c
 (With the depreciation accumulated to date)

Debit Cash / Bank / Receivable A/c
Credit Fixed Asset Disposal A/c
 (With the price at which asset is sold)

Example

- An asset is purchased for Rs. 500,000 on Nov. 01, 2001.
- Depreciation rate is 10% p.a.
- The Asset is sold on Apr. 30, 2004.
- Financial Year is July 1 to June 30

Required:

Calculate the WDV For both policies

Depreciation is charged on the Basis of Use

Year	On the Basis of Use	Rs.
1-11-2001	Cost	500,000
2001-2002	Dep. $500,000 \times 10\% \times 8 / 12$	(33,333)
30-6-2002	WDV	466,667
2002-2003	Dep. $466,666 \times 10\%$	(46,667)
30-6-2003	WDV	420,000
2003-2004	Dep. $420,000 \times 10\% \times 10 / 12$	(35,000)
30-4-2004	WDV	385,000

Full Depreciation in the Year of Purchase

Year	Full Dep. in year of Purchase	Rs.
1-11-2001	Cost	500,000
2001-2002	Dep. $500,000 \times 10\%$	(50,000)
30-6-2002	WDV	450,000
2002-2003	Dep. $450,000 \times 10\%$	(45,000)
30-6-2003	WDV	405,000
2003-2004	Dep. 00 in the year of sale	00
30-6-2004	WDV	405,000

Contents of Fixed Assets Register

- Different record for each class of assets
- Date of purchase
- Detailed particulars of asset
- Location of asset
- Record of depreciation

Illustration

Cost of asset	Rs. 200,000
Life of the asset	5 years
Depreciation method	Straight line
Residual value	Rs. 20,000
Sale price after 5 years	Rs.30,000

Calculate profit/Loss on the sale of the asset?

Solution

Written down value = 200,000 – 20,000 = 180,000

Depreciation/year = 180,000/5 = 36,000 (Straight line method)

Particulars	Depreciation (Rs)	Written Down Value (Rs.)
Cost		200,000
Dep. Of the 1 st year	(36,000)	164,000
Dep. Of the 2 nd year	(36,000)	128,000
Dep. Of the 3 rd year	(36,000)	92,000
Dep. Of the 4 th year	(36,000)	56,000
Dep. Of the 5 th year	(36,000)	20,000

Book value after five years	Rs. 20,000
Sale price	Rs. 30,000
Profit on sale	Rs. 10,000 (30,000 – 20,000)

Same illustration is solved by reducing balance method

Cost of asset	Rs. 200,000
Residual value	Rs. 20,000
Estimated useful life	5 years

Calculation of depreciation rate

$$\begin{aligned} \text{Depreciation Rate} &= 1 - \sqrt[n]{R_v/c} \\ &= 1 - \sqrt[5]{20,000/200,000} \\ &= 37\% \end{aligned}$$

Allocation of depreciation is given below:

Particulars	Depreciation (Rs)	Accumulated Depreciation (Rs.)	Written Down Value (Rs.)
Cost			200,000
Dep. Of the 1 st year 200,000 x 37%	74,000	74,000	126,000
Dep. Of the 2 nd year 126,000 x 37%	46,620	120,620	79,380
Dep. Of the 3 rd year 79,380 x 37%	29,371	149,991	50,009
Dep. Of the 4 th year 50,009 x 37%	18,503	168,494	31,506
Dep. Of the 5 th year 31,506 x 37%	11,657	180,151	19,849

Book value after five years

Rs. 19,849

Sale price

Rs. 30,000

Profit on sale

Rs. 10,151 (30,000 – 19,849)

Lesson-19**METHODS OF CHARGING DEPRECIATION (Continued)**

If an asset is not completed at that time when balance sheet is prepared, all costs incurred on that asset up to the balance sheet date are transferred to an account called **Capital Work in Progress Account**. This account is shown separately in the balance sheet below the fixed asset. Capital work in progress account contains all expenses incurred on the asset until it is converted into working condition. All these expenses will become part of the cost of that asset. When an asset is completed and it is ready to work, all costs in the capital work in progress account will transfer to the relevant asset account through the following entry:

Debit:	Relevant asset account
Credit:	Capital work in progress account

Illustration # 1

A machine is purchased for Rs. 400,000. Its useful life is estimated to be five years. Its residual value is Rs. 25,000. After four years, it was sold for Rs. 40,000. For the purpose of WDV, its depreciation rate is 40%.

You are required to show calculation of depreciation for four years. Also calculate profit or loss on disposal.

Solution**Calculation of depreciation and profit & loss on the basis of straight line method:**

$$\text{Depreciation/year} = (400,000 - 25,000)/5 = 75,000 \text{ (Straight line method)}$$

As, machine was sold after four years but its useful life was estimated for five years, when we calculate depreciation of the asset under straight line method, we will divide its WDV over five years, not on four years.

Particulars	Depreciation (Rs)	Written Down Value (Rs.)
Depreciable cost		400,000
Dep. Of the 1 st year	(75,000)	325,000
Dep. Of the 2 nd year	(75,000)	250,000
Dep. Of the 3 rd year	(75,000)	175,000
Dep. Of the 4 th year	(75,000)	100,000

Book value after four years	Rs. 100,000
Sale price	Rs. 40,000
Profit/(loss) on sale	Rs. (60,000) i.e.(40,000 –100,000)

Calculation of depreciation and profit & loss on the basis of reducing balance method:

Depreciation rate = 40%

Particulars	Depreciation (Rs)	Accumulated Depreciation (Rs.)	Written Down Value (Rs.)
Depreciable cost			400,000
Dep. Of the 1 st year 400,000 x 40%	160,000	160,000	240,000
Dep. Of the 2 nd year 240,000 x 40%	96,000	256,000	144,000
Dep. Of the 3 rd year 144,000 x 40%	57,600	313,600	86,400
Dep. Of the 4 th year 86,400 x 40%	34,560	348,160	51,840

Book value after four years

Rs. 51,840

Sale price

Rs. 40,000

Profit/ (loss) on sale

Rs. (11,840) i.e. (40,000 – 51,840)

Illustration # 2

Following information of machinery account is available in Year 2004:

- Machine # 1 is purchased on September 1, 2000 for Rs. 100,000
- Machine # 2 is purchased on January 31, 2002 for Rs. 200,000
- Machine # 3 is purchased on July 1, 2003 for Rs. 50,000
- Machine # 1 is disposed on March 31, 2004

Depreciation is charged @ 25% reducing balance method. Financial year is closed on June 30 every year.

Show the calculation of depreciation on machinery for four years using the following policies:

- Depreciation is charged on the basis of use
- Full depreciation is charged in the year of purchase and no depreciation is charged in the year of disposal.

Solution

Depreciation on the basis of use

Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-09-2000	100,000	Machine # 1 $100,000 \times 25\% \times 10/12 = \mathbf{20,833}$	Machine # 1 20,833	20,833	Machine # 1 79,167	79,167
2001-2002 31-01-2002	200,000	Machine # 1 $79,167 \times 25\% = \mathbf{19,792}$ Machine # 2 $200,000 \times 25\% \times 5/12 = \mathbf{20,833}$	Machine # 1 40,625 Machine # 2 20,833	61,458	Machine # 1 59,375 Machine # 2 179,167	238,542
2002-2003		Machine # 1 $59,375 \times 25\% = \mathbf{14,844}$ Machine # 2 $179,167 \times 25\% = \mathbf{44,792}$	Machine # 1 55,469 Machine # 2 65,625	121,094	Machine # 1 44,531 Machine # 2 134,375	178,906
2003-2004 01-07-2003	50,000	Machine # 1 $44,531 \times 25\% \times 9/12 = \mathbf{8,350}$ Machine # 2 $134,375 \times 25\% = \mathbf{33,594}$ Machine # 3 $50,000 \times 25\% = \mathbf{12,500}$	Machine # 1 63,819 Machine # 2 99,219 Machine # 3 12,500	175,538	Machine # 1 (36,181) (sold) Machine # 2 100,781 Machine # 3 37,500	138,281

Full year depreciation in the year of purchase and no depreciation in the year of sale:

Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-09-2000	100,000	Machine # 1 $100,000 \times 25\%$ =25,000	Machine # 1 25,000	25,000	Machine # 1 75,000	75,000
2001-2002	200,000	Machine # 1 $75,000 \times 25\%$ = 18,750	Machine # 1 43,750	93,750	Machine # 1 56,250	206,250
31-01-2002		Machine # 2 $200,000 \times 25\%$ =50,000	Machine # 2 50,000		Machine # 2 150,000	
2002-2003		Machine # 1 $56,250 \times 25\%$ = 14,063	Machine # 1 57,813	145,313	Machine # 1 42,187	154,687
		Machine # 2 $150,000 \times 25\%$ =37,500	Machine # 2 87,500		Machine # 2 112,500	
2003-2004	50,000	Machine # 1 0	Machine # 1 57,813	185,935	Machine # 1 42,187	121,875
		Machine sold	(sold)		Machine # 2 115,625	
01-07-2003		Machine # 2 $112,500 \times 25\%$ = 28,125	Machine # 2 115,625		Machine # 2 84,375	
		Machine # 3 $50,000 \times 25\%$ = 12,500	Machine # 3 12,500		Machine # 3 37,500	

Lesson-20**DEPRECIATION ON PURCHASE AND DISPOSAL OF FIXED ASSETS**

If an asset is not completed at that time when balance sheet is prepared, all costs incurred on that asset up to the balance sheet date are transferred to an account called **Capital Work in Progress Account**. This account is shown separately in the balance sheet below the fixed asset. Capital work in progress account contains all expenses incurred on the asset until it is converted into working condition. All these expenses will become part of the cost of that asset. When any expense is incurred or paid, it is included in the Capital Work in Progress Account through the following entry:

Debit:	Work in Progress Account
Credit:	Cash/Bank/Payable Account

When an asset is completed and it is ready to work, all costs will transfer to the relevant asset account through the following entry:

Debit:	Relevant asset account
Credit:	Capital work in progress account

Presentation

It is already mentioned that Work in Progress Account is shown separately in the balance sheet below the fixed asset. i-e.

Name of the Entity		
Balance Sheet As At.....		
Particulars	Amount Rs.	Amount Rs.
<u>Assets</u>		
Fixed Assets		xyz
Capital Work in Progress		xyz
Other Long Term Assets		xyz
Current Assets		
Total		xyz
<u>Liabilities</u>		
Capital	xyz	
Profit	xyz	xyz
Long Term Liabilities		xyz
Current Liabilities		
Total		xyz

Consider the solved illustration in the previous lecture:

Depreciation on the basis of use

Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-09-2000	100,000	Machine # 1 $100,000 \times 25\% \times 10/12 = 20,833$	Machine # 1 20,833	20,833	Machine # 1 79,167	79,167
2001-2002		Machine # 1 $79,167 \times 25\% = 19,792$	Machine # 1 40,625	61,458	Machine # 1 59,375	238,542
31-01-2002	200,000	Machine # 2 $200,000 \times 25\% \times 5/12 = 20,833$	Machine # 2 20,833		Machine # 2 179,167	
2002-2003		Machine # 1 $59,375 \times 25\% = 14,844$ Machine # 2 $179,167 \times 25\% = 44,792$	Machine # 1 55,469 Machine # 2 65,625	121,094	Machine # 1 44,531 Machine # 2 134,375	178,906
2003-2004		Machine # 1 $44,531 \times 25\% \times 9/12 = 8,350$ Machine # 2 $134,375 \times 25\% = 33,594$ Machine # 3 $50,000 \times 25\% = 12,500$	Machine # 1 63,819 Machine # 2 99,219 Machine # 3 12,500	175,538	Machine # 1 (36,181) (sold) Machine # 2 100,781 Machine # 3 37,500	138,281
01-07-2003	50,000					

Presentation in Balance Sheet

Year	Cost of Machinery Rs.	Accumulated Depreciation Rs.	Written Down Value Rs.
2000-2001	100,000	20,833	79,167
2001-2002	300,000	61,458	238,542
2002-2003	300,000	121,094	178,906

Written down Value of the year 2003-2004

Opening Written Down Value:	178,906
Add: Cost of machine purchased:	50,000
Less: Depreciation of Machine # 1 in 2003-2004:	(8,350)
Less: Depreciation of other assets:	(46,094)
Less: Written Down Value of machine disposed:	(36,181)

Closing Written Down Value:	138,281
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Full year depreciation in the year of purchase and no depreciation in the year of sale:

Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-09-2000	100,000	Machine # 1 $100,000 \times 25\%$ =25,000	Machine # 1 25,000	25,000	Machine # 1 75,000	75,000
2001-2002		Machine # 1 $75,000 \times 25\%$ = 18,750	Machine # 1 43,750	93,750	Machine # 1 56,250	206,250
31-01-2002	200,000	Machine # 2 $200,000 \times 25\%$ =50,000	Machine # 2 50,000		Machine # 2 150,000	
2002-2003		Machine # 1 $56,250 \times 25\%$ = 14,063	Machine # 1 57,813	145,313	Machine # 1 42,187	154,687
		Machine # 2 $150,000 \times 25\%$ =37,500	Machine # 2 87,500		Machine # 2 112,500	
2003-2004		Machine # 1 0	Machine # 1 57,813	185,935	Machine # 1 42,187	121,875
		Machine sold	(sold)		(sold)	
		Machine # 2 $112,500 \times 25\%$ = 28,125	Machine # 2 115,625		Machine # 2 84,375	
01-07-2003	50,000	Machine # 3 $50,000 \times 25\%$ = 12,500	Machine # 3 12,500		Machine # 3 37,500	

Presentation in the Balance Sheet

Year	Cost of Machinery Rs.	Accumulated Depreciation Rs.	Written Down Value Rs.
2000-2001	100,000	25,000	75,000
2001-2002	300,000	93,750	206,250
2002-2003	300,000	145,313	154,687

Written down Value of the year 2003-2004

Opening Written Down Value:	Rs. 154,687
Add: Cost of machine purchased:	Rs. 50,000
Less: Depreciation of Machine # 1 in 2003-2004:	0
Less: Depreciation of other assets:	(40,625)
Less: Written Down Value of machine disposed:	(42,187)

Closing Written Down Value:	Rs. 121,875
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Illustration # 2

Following information of machinery account is available in Year 2004:

- Machine # 1 is purchased on August 1, 2000 for Rs. 50,000
- Machine # 2 is purchased on April 1, 2002 for Rs. 100,000
- Machine # 3 is purchased on March 1, 2004 for Rs. 150,000
- Machine # 1 is disposed on May 31, 2004

Depreciation is charged @ 20% reducing balance method. Financial year is closed on June 30 every year.

Show the calculation of depreciation on machinery for four years using the following policies:

- Depreciation is charged on the basis of use
- Full depreciation is charged in the year of purchase and no depreciation is charged in the year of disposal,

Solution**Depreciation on the basis of use**

Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-08-2000	50,000	Machine # 1 $50,000 \times 20\% \times 11/12 = 9,167$	Machine # 1 9,167	9,167	Machine # 1 9,167	40,833
2001-2002 01-04-2002	100,000	Machine # 1 $40,833 \times 20\% = 8,167$ Machine # 2 $100,000 \times 20\% \times 3/12 = 5,000$	Machine # 1 17,334 Machine # 2 5,000	22,334	Machine # 1 32,666 Machine # 2 95,000	127,666
2002-2003		Machine # 1 $32,666 \times 20\% = 6,533$ Machine # 2 $95,000 \times 20\% = 19,000$	Machine # 1 23,867 Machine # 2 24,000	47,867	Machine # 1 26,133 Machine # 2 76,000	102,133
2003-2004 01-03-2004	150,000	Machine # 1 $26,133 \times 20\% \times 11/12 = 4,791$ Machine # 2 $76,000 \times 20\% = 15,200$ Machine # 3 $150,000 \times 20\% \times 4/12 = 10,000$	Machine # 1 28,658 Machine # 2 39,200 Machine # 3 10,000	77,858	Machine # 1 (21,342) (sold) Machine # 2 60,800 Machine # 3 140,000	200,800

Presentation in the Balance Sheet

Year	Cost of Machinery Rs.	Accumulated Depreciation Rs.	Written Down Value Rs.
2000-2001	50,000	9,167	40,833
2001-2002	150,000	22,334	127,666
2002-2003	150,000	47,867	102,133

Written Down Value of the year 2003-2004

Opening Written Down Value:	Rs. 102,133
Add: Cost of machine purchased:	Rs. 150,000
Less: Depreciation of Machine # 1 in 2003-2004:	(4,791)
Less: Depreciation of other assets:	(25,200)
Less: Written Down Value of machine disposed:	(21,342)

Closing Written Down Value:	Rs. 200,800
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Full year depreciation in the year of purchase and no depreciation in the year of sale:

Date	Purchase of machine (Rs.)	Depreciation (Rs.)	Accumulated depreciation (Rs.)	Total Accum. Dep.	Written Down Value (Rs.)	Total Written Down Value (Rs.)
01-08-2000	50,000	Machine # 1 $50,000 \times 20\%$ =10,000	Machine # 1 10,000	10,000	Machine # 1 40,000	40,000
2001-2002		Machine # 1 $40,000 \times 20\%$ = 8,000	Machine # 1 18,000	38,000	Machine # 1 32,000	112,000
01-04-2002	100,000	Machine # 2 $100,000 \times 20\%$ =20,000	Machine # 2 20,000		Machine # 2 80,000	
2002-2003		Machine # 1 $32,000 \times 20\%$ = 6,400	Machine # 1 24,400	60,400	Machine # 1 25,600	89,600
		Machine # 2 $80,000 \times 20\%$ =16,000	Machine # 2 36,000		Machine # 2 64,000	
2003-2004		Machine # 1 0	Machine # 1 24,400 (sold)	103,200	Machine # 1 (25,600) (sold)	171,200
		Machine sold Machine # 2 $64,000 \times 20\%$ = 12,800	Machine # 2 48,800		Machine # 2 51,200	
01-03-2004	150,000	Machine # 3 $150,000 \times 20\%$ = 30,000	Machine # 3 30,000		Machine # 3 120,000	

Presentation in the Balance Sheet

Year	Cost of Machinery Rs.	Accumulated Depreciation Rs.	Written Down Value Rs.
2000-2001	50,000	10,000	40,000
2001-2002	150,000	38,000	112,000
2002-2003	150,000	60,400	89,600

Written Down Value of the year 2003-2004

Opening Written Down Value:	Rs. 89,600
Add: Cost of machine purchased:	Rs. 150,000
Less: Depreciation of Machine # 1 in 2003-2004:	0
Less: Depreciation of other assets:	(42,800)
Less: Written Down Value of machine disposed:	(25,600)
Closing Written Down Value:	Rs. 171,200

Revaluation of Fixed Assets

Fixed assets are purchased to be used for longer period. In the subsequent years, the value of asset could be higher or lower than its present book value due to inflationary condition of the economy. Assets are valued at Historical Cost in the books of accounts. Historical Cost is the original cost of the asset at which it was purchased plus additional costs incurred on the asset to bring it in working condition. Sometimes, the management of the business, if it thinks fit, revalues the asset to present it on current market value. Once the asset is revalued to its market value, then its value has to be constantly monitored to reflect the changes in the market value.

If an asset is revalued at higher cost than its original cost, the excess amount will be treated as profit on revaluation of fixed assets and it is credited to Revaluation Reserve Account.

On the other hand, if an asset is revalued at lower cost than its original cost, the balance amount will be treated as loss on revaluation of fixed assets and it is shown in the profit & loss account of that year in which asset was revalued.

Lesson-21**REVALUATION OF FIXED ASSETS**

Fixed assets are purchased to be used for longer period. In the subsequent years, the value of asset could be higher or lower than its present book value due to inflationary condition of the economy. Assets are valued at Historical Cost in the books of accounts.

Historical Cost

Historical cost is the original cost of the asset at which it was purchased plus additional costs incurred on the asset to bring it in working condition. Sometimes, the management of the business, if it thinks fit, revalues the asset to present it at current market value. Once the asset is revalued to its market value, then its value has to be constantly monitored to reflect the changes in the market value.

Recording the effects of Revaluation of an Assets

If an asset is revalued at higher cost than its original cost, the excess amount will be treated as profit on revaluation of fixed assets and it is credited to Revaluation Reserve Account.

On the other hand, if an asset is revalued at lower cost than its original value, the balance amount will be treated as loss on revaluation of fixed assets and it is shown in the profit & loss account of that year in which asset was revalued.

Fair Value

It is the value, at which an asset would bring to the management, when sold to a knowledgeable party in a fair deal.

Rules for Revaluation

- Revaluation has to be carried out at regular intervals
- The change in the value should be permanent
- Whole class of asset has to be revalued

Illustration

An asset is purchased at the cost of Rs. 300,000. It was decided by the management that depreciation would be charged @ 20 % on the basis of straight line method. At the end of third year, following information is given:

Accumulated Depreciation	Rs. 180,000
Written Down Value	Rs. 120,000

The management has decided to revalue it to the current market value. The current market value of the asset is 180,000. You are required to make the necessary adjustments.

Solution

There are two options for making adjustments for the above mentioned changes:

1. Charge the accumulated depreciation to the cost of asset and increase the value of asset with the difference of current market value and WDV.
2. Calculate the proportion of increase and increase the cost of asset and accumulated depreciation with that proportion.

Option # 1

The accumulated depreciation is charged off against the cost of asset with the help of following entry:

Debit:	Accumulated Depreciation	180,000
Credit:	Cost of asset A/c	180,000

Cost of asset is increased to current market value, i.e., Rs.180,000. The difference between current market value and WDV is Rs. 60,000 (180,000 – 120,000). The credit is given to Revaluation Reserve Account.

Debit:	Cost of asset A/c	60,000
Credit:	Revaluation Reserve A/c	60,000

Option # 2

Both Cost and Accumulated Depreciation are increased in a proportionate manner so that the resulting Book Value is equal to the revalued amount.

Desired increase in WDV:

$$180,000 - 120,000 = 60,000$$

Rs.60,000 is 50% of 120,000. Therefore desired increase in Cost and Accumulated Depreciation is 50%.

Cost is increased by 50% by following entry:

Debit:	Cost of asset A/c	150,000
Credit:	Revaluation Reserve A/c	150,000

Accumulated depreciation is increased by 50% with the help of the following entry:

Debit:	Revaluation Reserve A/c	90,000
Credit:	Accumulated Depreciation A/c	90,000

Capital and Revenue Expenses

Capital Expenses are those expenses for which benefit is enjoyed for more than one accounting period. For example, the business has bought a car. Now, car will be used for many years. So, it is a capital expense. Capital Expenditure generally adds Fixed Asset Units or increases economic life, capacity or efficiency of existing fixed assets. The term used for Capital expenditures is 'Capitalized'.

Capital Expenditures are incurred in two ways:

- When an asset is acquired, and
- When an improvement is made in an existing asset.

All the expenditure incurred up to the point of bringing the asset to its intended use is capitalized as the initial cost of asset.

An expenditure that improves the performance of an asset from its originally assessed performance is termed as capital expenditure. However, the expenditure incurred on the maintenance of an asset is treated as Revenue Expense.

Revenue Expenses are those expenses for which, the benefit is enjoyed within one accounting period. For example, the business has purchased stationery for office use. Now, the stationery is used within one year in the office. So, this will be a revenue expense. The term used for Revenue Expenditures is 'Charged Off'.

Revenue Expenses are those expenses that are:

- Incurred in day to day running of the business.
- Incurred to maintain fixed assets in their original / useable condition.

All Capital Expenses are grouped in balance sheet & all Revenue expenses are grouped in Profit & Loss account.

Distinction between Capital Expenditure & Revenue Expenditure

Capital Expenditure	Revenue Expenditure
Its effect is long term, i.e. It is not exhausted within the current accounting period. Its benefit is received for a number of years in future.	Its effect is short term, i.e. The benefit is received within one accounting period.
Expenditure is said to be capital expenditure when an asset is acquired or performance of an existing asset is increased.	Neither an asset is acquired nor is the performance of any asset increased.
It does not occur again and again. It is non- recurring and irregular.	It is recurring and regular and it occurs repeatedly.
This expenditure improves the financial position of the business.	This expenditure helps to maintain the business.
A portion of this expenditure (Depreciation on asset) is shown in the profit & loss account and the balance is shown in the balance sheet on asset side.	The whole amount of this expenditure is shown in the profit & loss account or income statement.
It appears in the balance sheet until its benefit is fully exhausted.	It does not appear in the balance sheet.
It does not reduce the profit of the concern.	It reduces the profit of the concern.

Deferred Expenditure

The revenue expenditure that provides benefit for more than one year is called deferred expenditure. It is initially shown in balance sheet. Subsequently, it is charged to profit and loss account over the period in which benefit is derived from it.

Prepaid Expenses are amounts that are paid in advance to a vender or creditor for goods and services. Typically, insurance premiums are paid in advance of the coverage contained in the policy. Prepaid Expenses is a Current Asset for our business. This is because we have paid for something and someone owes us the service or the goods for which we prepaid.

The General Rule

The general rule for distinguishing between capital and revenue expenditure is as follows:

- The expense whose benefit lasts for a period longer than an accounting period is called capital expenditure, and
- The expense whose benefit is obtained within an accounting period is termed as a revenue expense.

Exceptions

Depending upon the size of expenditure and policy of the organization, following expenditures can be “Charged to Profit and Loss” instead of “Capitalizing”.

- **Legal Charges** – are as per rule charged to P & L but when these are incurred to acquire an asset these should be capitalized with the asset.
- **Repairs** – are also charged to P&L but when it is of such nature that it enhances the performance of an asset from its original performance than it should be capitalized.
- **Wages** – are normally revenue expense but when these are paid to men employed to create an asset these should be capitalized as the cost of asset.

- **Freight and Carriage** – normally a revenue expense, but when paid to bring an asset to its intended use then it is treated as capital.
- **Interest on Loan** – is normally revenue expenditure but when the loan is taken to purchase an asset its interest is treated as Capital and is added to cost of the asset.

Capital and Revenue Receipts

Capital Receipts

Receipts which are non-recurring and whose benefits are enjoyed over a long period are called 'Capital Receipts'. For instance, Capital invested, Loan from bank, Sale proceed of fixed assets etc. Capital receipts are shown on the liability side of the balance sheet.

Revenue Receipts

Receipts which are recurring by nature and which are available for meeting all day to day expenses of a business concern are known as 'Revenue Receipts'. For example, sale proceeds of goods, interest received, rent received etc.

Lesson-22**BANK RECONCILIATION STATEMENTS**

After reading this lecture, you will be able to understand that:

- What are Banking transactions, and
- How a Bank reconciliation statement is made?

Bank Book and Bank Statement

Bank statement is the detail of transactions in one's account provided by the bank.

We should understand one thing that our money lying in the bank is an asset for us. But for bank, it is a liability as the bank has a responsibility to return that money to us.

Therefore, when we see a bank statement, it looks like a mirror image of our bank book. That is, when we (customer) invest money into bank account, our asset (Bank account) increases. So we Debit our account. Whereas bank's liability increases. As the customer account is the liability for the bank because it has to pay the invested money back to the customer. So our account is credited in its books.

Standard format of Bank book is given hereunder:

XYZ Traders			Bank Book (Bank Account Number)			Account Code --	
Date 20--	Vr. #	Chq. No.	Narration/Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)
Jul 01			Opening Balance		50,000		50,000
Jul 02		12345	Paid to Mr. Umer			10,000	40,000
Jul 03			Cash Deposit in Bank		5,000		45,000
Jul 03		12346	Paid to Mr. Ali			12,000	33,000

Standard format of Bank Statement is given hereunder:

ABC Bank		Bank Statement Account No. xxxxx		
Date 20--	Narration / Particulars	Withdrawals Amount	Deposits Amount	Balance Dr/(Cr)
Jul 01	Opening Balance as on Jul 01		50,000	(50,000)
Jul 02	Chq # 12345	10,000		(40,000)
Jul 03	Cash paid in		5,000	(45,000)
Jul 03	Chq # 12346	12,000		(33,000)

At times, banks show the amount in balance column against our General Rule (a credit balance is shown in brackets), just to facilitate the customers. The rule then becomes:

1. A balance favorable to the customer is shown without brackets
2. A balance favorable to bank is shown within brackets

Our bank statement of previous example will look like as follows.

ABC Bank Bank Statement Account No. xxxxx				
Date 20--	Narration / Particulars	Withdrawals Amount	Deposits Amount	Balance
Jul 01	Opening Balance as on Jul 01		50,000	50,000
Jul 02	Chq # 12345	10,000		40,000
Jul 03	Cash paid in		5,000	45,000
Jul 03	Chq # 12346	12,000		33,000

At times, banks record transactions in our account without our knowledge. e.g. bank charges, profit, tax. Sometimes, someone deposits money directly in our account that escapes recording in our books. This problem is solved by tracing figures from bank book to bank statement on periodic basis in order to update our record.

Example # 1

The Bank book of Ali Traders shows the following picture for the month of July, 2002:

Ali Traders		Bank Book (Bank Account Number)			Account Code --		
Date 20--	Vr. #	Chq. No.	Narration /Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)
Jul 01			Opening Balance		150,000		150,000
Jul 05		0001	Paid to XYZ			20,000	130,000
Jul 10			Cash Deposit in Bank		5,000		135,000
Jul 15		0002	Paid to ABC			25,000	110,000
Jul 20		0003	Paid to creditors			50,000	60,000

Balance as per bank book on July 31, is Rs. 60,000.

The Bank Statement of Ali Traders shows the following record for the month of July, 2002:

ABC Bank Bank Statement Account No. xxxxx For the period of _____				
Date 20--	Narration / Particulars	Withdrawals Amount	Deposits Amount	Balance
Jul 01	Opening Balance		150,000	150,000
Jul 05	Chq # 0001	20,000		130,000
Jul 10	Cash Deposit in Bank		5,000	135,000
Jul 15	Chq # 0001	25,000		110,000
Jul 20	Chq # 0001	50,000		60,000
Jul 31	Bank charges	500		59,500
Jul 31	Profit		700	60,200

Balance as per bank statement on Jul 31, is Rs. 60,200

When we trace the figures, we come to know that there are two transactions that have not been recorded in our books. i.e. Transactions of 'Bank charges' and 'Profit'

After recording these two transactions, the bank book of Ali Traders looks like as follows:

Ali Traders		Bank Book (Bank Account Number)			Account Code --		
Date 20--	Vr. #	Chq. No.	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)
Jul 01			Opening Balance		150,000		150,000
Jul 05		0001	Paid to XYZ			20,000	130,000
Jul 10			Cash Deposit in Bank		5,000		135,000
Jul 15		0002	Paid to ABC			25,000	110,000
Jul 20		0003	Paid to creditors			50,000	60,000
Jul 31			Bank charges			500	59,500
Jul 31			Profit		700		60,200

After recording the missing transactions, Balance as per bank book on Jul 31, is Rs. 60,200, which is the same as bank statement balance.

In the above example, dates of payments in bank book and bank statement are taken to be the same. In actual life, this is not always the case. We write out cheque to our creditor today, he will deposit in his bank tomorrow. The cheque will be presented in our bank by the creditor on the day after tomorrow. We have recorded the transaction today but the payment in our statement will appear at least 2 days later. This period can even be greater.

Similarly, we receive a cheque from our debtor today and record it in our books. The cheque will be deposited in bank tomorrow and it will take a few days to clear. Again, there will be a difference in date of our receipt and that of our bank.

Bank Reconciliation Statement

In the above example, it is assumed that a payment of Rs. 10,000 is made on 31 Jul, and it appears in the bank on Aug. 02. When figures will be traced from bank book to bank statement, this amount will remain un-ticked in the bank book in the month of July. No recording will be made in the books as they are already correct.

Under such circumstances, a statement called **Bank Reconciliation Statement** is made. This reconciles those differences in Bank Book and Bank Statement that cannot be adjusted by an accounting entry at that date on which balances are being reconciled.

Unpresented Cheques

The events discussed in above example, where a cheque is issued but it has not been presented in the account, such kind of cheques are called **Un-presented Cheques**. When this cheque is recorded, the bank book is credited with Rs. 10,000. Therefore, the balance as per Bank Book is Rs. 50,200 (60,200 - 10,000), whereas, the bank is still showing a balance of Rs. 60,200.

So, if we want to reconcile these balances, we will remove the effect of this entry (not in actual books but in the statement only). So the Statement Would:

Balance As Per Bank Book	Dr.	50,200
Un-presented Cheques	Dr.	<u>10,000</u>
Balance as Per Bank Statement	Cr.	<u>60,200</u>

Note the following things in the above statement:

- We have started with the balance of Bank Book
- To reverse the effect of Cr. entry in bank book, we have written Dr. with the figure.
- Since both figures (50,200 and 10,000) are Dr. therefore, they are added.
- We also know that balances in bank book and bank statement are exactly opposite to each other, therefore, Cr. has been written with the resulting figure (60,200)

Un-Credited Cheques

The other event discussed was of a receipt of a cheque that has not been cleared in the bank account as yet. To record a receipt, bank book should have been debited. Therefore, to reverse the effect of Credit will be written with the figure in the statement.

Assume that the above Rs. 10,000 was a receipt rather than a payment. Then, the balance in the bank book would be Rs. 70,200 (60,200 + 10,000).

The bank reconciliation will be as follows:

Balance As Per Bank Book	Dr.	70,200
Un-credited Cheques	Cr.	<u>(10,000)</u>
Balance As Per Bank Statement	Cr.	<u>60,200</u>

Example # 2

The Bank book of Usman Traders gives the following record for the month of December, 2002:

Usman Traders		Bank Book (Bank Account Number)			Account Code --		
Date 20--	Vr. #	Chq. No.	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)
Dec 01			Opening Balance		150,000		150,000
Dec 07			Received form Anwer		10,000		160,000
Dec 08		57000	Paid to Tariq			19,500	140,500
Dec 15		57001	Paid to Shabbir			4,000	136,500
Dec 22			Received from Javed		9,700		146,200
Dec 28		57002	Paid to Salim			9,100	137,100
Dec 31			Received from Javed		20,000		157,100
Dec 31			Received form Rashid		17,800		174,900
Dec 31							

The Bank Statement of Usman Traders shows the following picture:

ABC Bank		Bank Statement Account No. xxxxx		
Date 20--	Narration / Particulars	Withdrawals Amount	Deposits Amount	Balance
Dec 1	Balance B/f			150,000
Dec 7	deposits		10,000	160,000
Dec 11	57000	19,500		140,500
Dec 20	57001	4,000		136,500
Dec 22	deposits		9,700	146,200
Dec 31	Charges	2,200		144,000

You are required to reconcile Bank book with Bank Statement and prepare Bank Reconciliation Statement.

Solution

While tracing figures from bank book to bank reconciliation statement, it is noticed that bank charges deducted by bank are not booked in bank book. So, bank charges will be booked through the following adjusting entry:

Debit:	Bank charges	2,200
Credit:	Bank A/c	2,200

The corrected bank book is hereunder:

Usman Traders		Bank Book (Bank Account Number)			Account Code --		
Date 20--	Vr. #	Chq. No.	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)
Dec 01			Opening Balance		150,000		150,000
Dec 07			Received form Anwer		10,000		160,000
Dec 08		57000	Paid to Tariq			19,500	140,500
Dec 15		57001	Paid to Shabbir			4,000	136,500
Dec 22			Received from Javed		9,700		146,200
Dec 28		57002	Paid to Salim			9,100	137,100
Dec 31			Received from Javed		20,000		157,100
Dec 31			Received form Rashid		17,800		174,900
Dec 31			Bank charges			2,200	172,700

It was also noticed that a cheques of Rs. 9,100 given to Salim on December 28 was not paid by bank as yet. So, it is an un-presented cheque. Cheques received from Javed and Rashid worth of Rs. 20,000 and 17,800 respectively are not credited by bank till December 31, 2002. These are un-credited cheques of Usman Traders.

Bank Reconciliation Statement of Usman Traders shows the following picture:

Usman Traders
Bank Reconciliation Statement
As at Dec. 31, 2002

	(Rs.)
Balance as per bank book	Dr. 172,700
Un-presented cheques	Dr. 9,100
Un-credit cheques	(20,000)
	<u>(17,800)</u>
Balance as per bank statement	Cr. 144,000

Lesson-23**BANK RECONCILIATION STATEMENTS (Contd.)**

In the last lecture, we studied what is Bank Statement and how does it differ from our Bank Book. We told you that money lying in our bank account is our asset. Therefore, it usually has a DEBIT BALANCE. Also, when we deposit cash in our Bank, we DEBIT the Bank Book / Bank Account. Whereas, for Bank, the money lying in our Bank Account is a liability that bank has to return to us. Therefore, in Bank Statement which is a ledger account for bank normally has a CREDIT BALANCE. When we deposit cash in our bank account the liability of the bank to pay us increases. Therefore, our account in the Books of Bank is CREDITED. Bank Statement is, therefore, a MIRROR IMAGE of our bank book.

Then, we studied about the reasons that create differences between our bank book and bank statement. Such as:

- Bank Charges debited to our bank account by the bank without our knowledge
- Profit credited to our bank account
- Payments made on our behalf by the bank, through our standing instructions, that we did not record in our books
- Money paid in our account by our customers, dealers, agents, etc. without our knowledge
- Un-presented cheques
- Un-cleared cheques

The last two reasons arise because we record payments or receipts in our books when we receive / issue a cheque. But the bank records the transaction in our account at the time of actual receipts or payments. These differences are included in the bank reconciliation statement.

The first four items are either adjusted in the bank book or shown in the reconciliation statement, depending upon whether we have closed our books for the period or not. If we have closed our books of accounts, these differences will be presented in the bank reconciliation statement. If our books of accounts are not closed as yet, we will adjust our bank book and give effect of all these adjustments in the bank book.

The main idea behind bank reconciliation is that we adjust our bank book for the transactions, that remain untraced, either through a Voucher (charges, profit, standing instruction) or through a Reconciliation Statement (un-presented, un-credited cheques).

Example # 1

From the following particulars, prepare Bank reconciliation statement of Mr. Naveed as on June 30, 2002.

• Balance as per bank book	Dr.	32,000
• Cheques deposited but not yet collected by bank		20,200
• Cheques issued but not yet paid by bank		13,000
• Dividend credited by bank on June 30, but the intimation was received later		2,000
• Interest credited by bank		250
• Bank charges debited by bank		50

It is assumed that books of accounts are not closed yet.

Solution

As books of accounts are not closed, we will find out the adjusted balance first:

		Rs.
Balance as per bank book	Dr.	32,000
Add/Debit Dividend credited by bank	Dr.	2,000
Add/Debit Interest credited by bank	Dr.	250
Less/Credit Bank charges	Cr.	(50)
Adjusted balance as per bank book	Dr.	34,200

These adjustments in the ledger account of bank will look like as follows:

Mr. Naveed		Bank Book (Bank Account Number)			Account Code --		
Date	Vr. #	Chq. No.	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)
Jun30			Balance B/f		32,000		32,000
Jun30			Dividend received		2,000		34,000
Jun30			Interest received		250		34,250
Jun30			Bank charges			50	34,200

Bank Reconciliation Statement

		Rs.
Balance as per bank book	Dr.	34,200
Add: Un-presented cheques	Dr.	13,000
Less: Un-credited cheques	(Cr.)	(20,200)
Balance as per bank statement	Cr.	27,000

In this example, books of accounts are not closed, all other transactions except un-presented cheques and un-credited cheques, will be recorded in the bank book by passing journal entries and adjusted balance of bank book will be presented in the bank reconciliation statement.

To this point, we have considered a favourable balance i.e. Debit in bank book and Credit in bank statement. But there is a possibility that we may have an unfavourable balance.

This can happen if we have taken a loan from our bank. We can also call it an **overdraft** i.e. we have drawn more money from our bank than we had deposited in it. The reconciliation procedure would be the same as before.

The solution of above example will show the following picture:

Solution

As books of accounts are not closed, we will find out the adjusted balance first:

		Rs.
Balance as per bank book	Cr.	(32,000)
Add/Debit Dividend credited by bank	Dr.	2,000
Add/Debit Interest credited by bank	Dr.	250
Less/Credit Bank charges	Cr.	(50)
Adjusted balance as per bank book	Dr.	(34,200)

These adjustments in the ledger account of bank will look like as follows:

Mr. Naveed		Bank Book (Bank Account Number)			Account Code --		
Date 20--	Vr. #	Chq. No.	Narration / Particulars	Ledger Code	Receipt Amount	Payment Amount	Balance Dr/(Cr)
Jun30			Balance B/f			32,000	(32,000)
Jun30			Dividend received		2,000		(34,000)
Jun30			Interest received		250		(34,250)
Jun30			Bank charges			50	(34,200)

Bank Reconciliation Statement

	Rs.
Balance as per bank book	Cr. (34,200)
Add: Un-presented cheques	Dr. 13,000
Less: Un-credited cheques	(Cr.) (20,200)
Balance as per bank statement	Dr. (41,400)

In this case the balance of bank statement is debit because this amount is receivable by bank; it is an asset of the bank. On the other hand, this balance is a credit balance in bank book, it is payable to bank by the business. So, it is a liability of the business.

Balance of bank statement in the first case does not match with the balance calculated above. The reason being, the balance in the first solution was debit, i.e. Balance was our asset and drawing more money from bank reduced our asset. On the other hand, balance in this case is credit, i.e. We have already drawn more than what we have deposited in the bank. So, it is our liability. This balance is shown with negative sign. So, when we add/debit any amount, it will reduce our liability and when we less/credit any amount from bank, it will enhance our liability. This difference in treatment will result in a different balance of bank statement.

Example # 2

From the following data ascertain the balance as per bank statement of Rashid & Co on March 31, 20--

- Balance as per bank book Rs. 79,000
- Cheques issued but not presented for payment Rs. 24,000.
- Cheques deposited but not cleared Rs. 35,000
- Interest on deposit was credited by bank but not debited in bank book Rs. 1,000.
- A customer paid into bank directly Rs. 13,000 but the same was not recorded in bank book.
- Other receipts in bank that were not recorded in bank book Rs. 20,000.

Solution

In such an example, where bank reconciliation statement is not required the answer will show only what is required i.e. the balance that should appear in Bank Statement. Whereas, the reconciliation statement is prepared in Working / Rough Work

Let's see the solution now:

Rashid & Co.
Balance as per Bank Statement
As on March 21, 20_____

Working

Balance as per Bank Book	79,000
Add Un presented cheques	24,000
Less Un credited cheques	(35,000)
Add Interest received	1,000
Add amount deposited by customer	13,000
Add other receipts in bank	<u>20,000</u>
Balance as per bank statement	<u>102,000</u>

As this is a working, therefore, we have put all the items in the statement. If the question had required the adjusted bank book balance, then, we would have adjusted items 3, 4 and 5 first and then prepared the reconciliation statement.

Similarly, the question could have given us the balance as per bank statement and required us to calculate bank book balance.

Let's see how we will work out the balance of bank book:

Rashid & Co.
Balance as per Bank Statement
As on March 21, 20_____

Balance as per Bank Statement	102,000
Less Un presented cheques	(24,000)
Add Un credited cheques	35,000
Less Interest received	(1,000)
Less amount deposited by customer	(13,000)
Less other receipts in bank	<u>(20,000)</u>
Balance as per bank book	<u>79,000</u>

Rectification of Error

In the beginning of this lecture, we also said that one reason for a difference between balance of bank book and bank statement could be a mistake made by us in recording transactions. Such differences are removed by making an adjusting entry through Journal Voucher, which is also called **rectification of error**.

Any other error when rectified / corrected would also be termed as Rectification of Error.

For Example, assume that we received cash Rs. 50,000 from a debtor and instead of Debiting the Cash Book / Cash Account, we debited the Bank Book, whereas the credit was given to the correct account. Now we have overstated bank book by Rs. 50,000 and understated the cash book by the same amount. To correct this, we will have to reduce credit bank and increase debit cash by Rs. 50,000. So the entry will be:

Debit	Cash Account	50,000
Credit	Bank Account	50,000

After posting this transaction, our bank book will be reconciled if all other items have been taken into account.

We can prepare a general procedure for rectification of errors.

Step 1	Note down the correct entry		
	Debit: Cash	50,000	
	Credit: Creditors		50,000
Step 2	Note down the incorrect entry		
	Debit: Bank	50,000	
	Credit: Creditors		50,000
Step 3	See that Credit effect is correct. In case of Debit, effect has been given to Bank, instead of cash. Therefore, we will give the due effect to Cash by debiting it and Remove the incorrect effect from bank by crediting it.		
	Debit: Cash Account	50,000	
	Credit: Bank Account		50,000

This is one type of error where entry has been posted in incorrect account but with the correct amount.

Other errors that may occur while recording are as follows:

- A transaction is completely omitted. For example, in our above examples, we had not recorded the bank charges or the payment made by our customers directly in our bank.
- This type of errors is simple to rectify. The entry that was required at the time when event is recorded and comes to our knowledge.
- The entry is recorded in correct account but with incorrect amount. For example, Electricity bill of Rs. 1,000 paid in cash is recorded as Rs. 100 in correct head. In this case, rectification will be done by following entry:

Debit	Electricity	900	
Credit	Cash		900

(This will increase the expense to Rs. 1,000 and decrease the cash to the correct amount.)

- On the other hand, if the entry was recorded at 10,000. Then a reversal entry will be posted to correct the effect.

Debit:	Cash	9,000	
Credit:	Electricity		9,000

- Another type of error could be Wrong Head of Account with wrong amount. For example, Purchase of vehicle worth Rs. 500,000 through cheque is recorded as vehicle repair Rs. 50,000.

The Correct Entry would have been:

Debit:	Vehicle	500,000	
Credit:	Bank		500,000

The wrong entry that we posted is:

Debit:	Vehicle repair	50,000	
Credit:	Bank		50,000

Rectification will be as follows:

Debit:	Vehicle	500,000	
Credit:	Bank		450,000
Credit:	Vehicle Repair		50,000

We can, therefore, use this method to rectify any mistake.

Lesson- 24**DEBTORS, CREDITORS, ACCRUALS AND PROVISION FOR BAD DEBTS****Creditors**

Creditors are the third persons/parties, who owe money from the business. These are payables of the business against purchase of goods for resale purposes. It is liability of the business and is shown in balance sheet under the heading of 'current liabilities'.

While studying 'Accounting for Stocks', we studied about the accounting for Creditors and studied following transactions:

Purchase of Goods on credit

Debit:	Stocks Account
Credit:	Creditors Account

Goods Returned

Debit:	Creditors Account
Credit:	Stocks Account

At the time of Payment

Debit:	Creditors Account
Credit:	Cash / Bank Account

Discount Received

At times, we receive discounts from our creditors. This discount is either treated as income of the business or as a reduction in the cost of stock.

Debit:	Creditors
Credit:	Discount Received OR Stock

Accrued Expenses

When an expense or other payable is accrued, it also creates a current liability but it is not recorded as Creditors. It is shown separately as accrued expenses or expenses payable. The recording of these is as follows:

At the time of recording Accrual

Debit:	Relevant Expense Account
Credit:	Accrued Expenses / Expenses Payable

In case of any subsequent reduction in the expense

Debit:	Accrued Expenses / Expenses Payable
Credit:	Relevant Expense Account

At the time of making payment

Debit:	Accrued Expenses / Expenses Payable
Credit:	Cash / Bank

Difference Between Accrual & Provision

Both these terms are used to record an expense but with a minor difference:

- Accrual is recorded, when exact amount of expense is known at the time of recording. For example, when salaries are accrued at the end of month, a definite amount is known. It is, therefore, treated as Accrual.
- Provision is made, when it is known that an expense will arise but the exact amount is not known. For example, at the end of the month, when we record the expense of utilities, the exact amount is not known. Therefore, a provision for these expenses is made.

Accounting Treatment of Provision

Recording of Provisions is done just like Accruals.

At the time of recording Provision:

Debit:	Relevant Expense Account
Credit:	Provisions

At the time when exact amount is known, the provision is adjusted by Debiting or Crediting, to bring it to the exact amount of expense. Other effect is given to the account that was originally debited in above transaction.

At the time of making payment

Debit:	Provisions
Credit:	Cash / Bank

Creditors, Accruals and provisions are shown under current liabilities in the balance sheet.

Debtors

Debtors are the third persons/parties, from whom business owes money. These are receivables of the business against sale of goods. It is an asset of the business and is shown in the balance sheet under the heading of 'current assets'.

Accounting Treatment

We studied at the time of sale of Goods that Cost of goods sold is debited and Finished Goods Stock is credited.

The other entry that is booked is as follows:

Debit:	Cash / Bank / Debtors
Credit:	Sales / Revenue

At the time of receipt

Debit:	Cash / Bank
Credit:	Debtors

When goods sold to debtors are returned following entries are booked:

Debit:	Sales
Credit:	Debtors
(With the sale value of goods returned)	
Debit:	Finished Goods Stock
Credit:	Cost of Goods Sold
(With the cost of goods returned)	

This essentially reverses the effect of transactions recorded at the time of sale of goods

Bad Debts

When goods are sold on credit the business takes the risk that some of the customers may never pay for the goods sold to them. When a debtor does not pay the amount due to him, it is said to be a bad debt. This is a loss sustained as a result of a risk taken in the normal course of business. It is charged to Profit and Loss Account in the period in which it is sustained.

Recording of Bad Debts

In case of sales return, there were two entries to record, one to record a reduction of debtors and the other to record receipt of stock. In case of bad debts, debtors are reduced but no stock is returned.

Therefore, only one entry is passed, whereby Debtors are reduced and an expense is created titled “Bad Debts”

Debit:	Bad Debts	
	Credit:	Debtors a/c

At the time of preparing financial statements we have following objectives:

- To charge all the expenses for the period against the income.
- To show the figures in the balance sheet that present a true picture of financial position of the business as at that date.

Therefore, if it becomes obvious that some of the debtors may not pay the amount due to them, we need to charge that receivable to profit and loss. Like we said earlier, an accrual or expense is recorded when the definite amount is known, otherwise, a provision is made. Same is the case with debtors. When there is an indication that some debtors may not pay, a provision is created.

Recording of Provision

Debit:	Provision for Bad Debts (P&L)
Credit:	Provision for Bad Debts

The debit account is charged against current years profit and the credit head is shown as a deduction from debtors in the balance sheet.

Presentation of Provision for Bad Debts

Extract of P & L to show the Provision

Profit and Loss Account for the year ended June 30, 20—

Gross Profit	xxxxx
Less: Admin Expenses	
Provision for bad debts	(5,000)

Extract of Balance Sheet to show the Provision

Current Assets

Debtors	100,000
Provision for Bad Debts	<u>(5,000)</u>
	95,000

Bad Debts & Provision For Bad Debts

When the bad debt for which provision is already made is confirmed, following entry is passed:

Debit:	Provision for Bad Debts
Credit:	Debtors

As expense has already been charged, therefore, no effect is given to P&L at this point.

Reducing the provision

Debit:	Provision for Bad Debts (Balance Sheet)
Credit:	Provision for Bad Debts (P&L)

Increasing the provision

Debit: Provision for Bad Debts (P&L)
 Credit: Provision for Bad Debts

Example # 1

Following information is available for Abbas Ltd. for the year ended June 30, 2002.

Bad Debts During the year

November	100
January	780
April	350

At the year end total debtors amounted to Rs. 35,000 out of which Rs. 1,800 is considered to be bad. Show the bad relevant accounts and extracts from P&L and Balance Sheet.

Solution

Abbas Ltd.		Bad Debts Account			Account Code --	
Date 2002	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
Nov		Bad Debts		100		100
Jan		Bad Debts		780		880
Apr		Bad Debts		350		1,230

Abbas Ltd.		Provision for Bad Debts Account (B/S)			Account Code --	
Date 2002	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
June		Provision for Bad Debts			1,800	(1,800)

Abbas Ltd.		Provision for Bad Debts Account (P&L)			Account Code --	
Date 20--	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
Jun		Provision for Bad Debts		1,800		1,800

Presentation in Profit & Loss Account

Abbas Ltd.
Profit and Loss Account
For the year ended June 30, 2002.

Gross Profit	xxxxx
Less: Admin Expenses	
Bad Debts	(1,230)
Provision for bad debts	(1,800)

Presentation in Balance Sheet

Abbas Ltd.
Balance Sheet
As On June 30, 2002

Current Assets

Debtors	35,000	
Provision for Bad Debts	<u>(1,800)</u>	<u>33,200</u>

Example # 2

A business creates a provision for bad debts @ 5% of its debtors on balance sheet date.

- On July 01, 2001 the balance of Provision was 3,400.
- During the year debts written off amounted to Rs. 5,000.
- On June 30, 2002, debtors totaled Rs. 75,000.
- Show Bad debts Account and provision for bad debts account.

Solution

The required closing balance of Provision is Rs. 3,750 (75000 x 5%). Therefore a further provision of Rs. 350 (3,750 – 3,400) will have to be created.

Bad Debts Account				Account Code --		
Date 2002	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
June 30		Bad Debts		5,000		5,000

Provision for Bad Debts Account (B/S)				Account Code --		
Date	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
July01, 2001		O/B			3,400	(3,400)
June30, 2002		Provision for bad debts			350	(3,750)

Provision for Bad Debts Account (P&L)				Account Code --		
Date 2002	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
June30		Provision for Bad Debts		350		350

Lesson-25**PROVISION FOR BAD DEBTS AND CONTROL ACCOUNTS**

Debit: Provision for Bad Debts (P&L)
 Credit: Provision for Bad Debts

The debit account is charged against current years profit and the credit head is shown as a deduction from debtors in the balance sheet.

Presentation of Provision for Bad Debts**Extract of P & L to show the Provision:**

Profit and Loss Account	
For the year ended June 30, 20—	
Gross Profit	xxxxx
Less: <u>Admin Expenses</u>	
Provision for bad debts	<u>(5,000)</u>

Extract of Balance Sheet to show the Provision**Current Assets:**

Debtors	100,000	
Provision for Bad Debts	<u>(5,000)</u>	95,000

Recording Of Bad Debts & Provision for Bad Debts

When the bad debt for which provision is already made is confirmed, following entry is passed:

Debit: Provision for Bad Debts
 Credit: Debtors a/c

As expense has already been charged, therefore, no affect is given to P&L account at this point.

Reducing the provision

Debit: Provision for Bad Debts (Balance Sheet)
 Credit: Provision for Bad Debts (P&L)

Increasing the provision

Debit: Provision for Bad Debts (P&L)
 Credit: Provision for bad debts

Example # 1

Following information is available for A Ltd. For the year ended June 30, 2002.

Bad Debts During the year:	
November	1,100
January	640
April	120

At the year end total debtors amounted to Rs. 68,000 out which Rs. 2,200 is considered to be doubtful / bad. Show the relevant accounts and extracts from Profit and Loss and Balance Sheet.

Solution

A Ltd.		Bad Debts Account		Account Code --		
Date 2002	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
Nov 01		Bad Debts		1,100		1,100
Jan		Bad Debts		640		1,740
Apr		Bad Debts		120		1,860
June 30		Transfer to P&L			1,860	0

A Ltd. Provision for Bad and Doubtful Debts(P & L) Account Code --						
Date 2002	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
Jun 30		Provision for the Year		2,200		2,200
Jun 30		Transfer to P&L			2,200	0

A Ltd.		Provision for Bad and Doubtful Debts (B/S)		Account Code --		
Date 2002	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
Jun 30		Provision for the Year			2,200	(2,200)

Presentation in Profit & Loss account:

A Ltd.		-----
Profit and Loss Account		
For the year ended June 30, 2002		
Gross Profit		-----
Less: <u>Administration Expenses:</u>		
Bad Debts		(1,860)
Provision for bad debts		<u>(2,200)</u>

Presentation in Balance sheet:

A Ltd.
Balance Sheet
As On June 30, 2002

Current Assets:

Debtors	68,000	
Provision for Bad Debts	<u>(2,200)</u>	<u>65,800</u>

Example # 2

A business creates a provision for bad debts @ 5% of its debtors on balance sheet date.

- On Jan 01, 2002 the balance of Provision was 6,600.
- During the year debts written off amounted to Rs. 5,400.

- On December 31, 2002, debtors totaled Rs. 62,000.
- Show Bad debts Account and provision for bad debts account.

Solution

Required closing balance of Provision = $62000 \times 5\% = 3,100$

Provision for Bad and Doubtful Debts Account (B/S)				Account Code --		
Date 2002	Vr. #	Narration / Particulars	Ledger Code	DR. Amount	CR. Amount	Balance Dr/(Cr)
Jan 01		Opening Balance			6,600	(6,600)
		Bad Debts		5,400		(1,200)
Dec 31		Provision for bad debts			1,900	(3,100)

Presentation in balance sheet:

XYZ,
Balance Sheet,
As on _____

Current Assets:

Debtors	62,000	
Provision for Bad Debts	<u>(3,100)</u>	58,900

Control Accounts

We have studied about Purchases, Sales, Debtors and Creditors in our previous lectures. We have also studied that trial balance works as a check of mathematical accuracy of the book keeping. If the trial balance is not balanced, then it indicates an error in recording of transactions. To detect this error one has to go through all the transactions during the year to detect the error. Now, if the size of the business is small, it would be easier to detect the difference. But if the business is large, then it becomes difficult to detect the difference. To solve this problem, a system of checks is devised so that the ledger accounts are distributed in smaller groups and a trial is prepared for every group.

Usually with the growth of business, the number of suppliers (creditors) and customers (debtors) grow. So, if we open a separate ledger account for every creditor and debtor, then the general ledger and trial balance would become too voluminous to manage. Therefore, in order to simplify things, one ledger each is maintained for Debtors and Creditors. The Debtors Ledger is called Total Debtors Ledger or **Sales Ledger Control Account** (as Credit sales are recorded in this account). The Creditors Ledger is called Total Creditors Ledger or **Purchase Ledger Control Account** (as Credit purchases are recorded in this ledger). In General Ledger one account is kept for all the Debtors, called **Debtors Control Account**, and one for Creditors, called **Creditors Control Account**.

The principle on which control accounts are based is simple and as follows:

- If the opening balance of an account is known, together with the total of deductions and additions entered in the account, the closing balance can be calculated.
- The same method is applied to the whole ledger, the total of opening balances together with the additions and deductions during the period should give the total of closing balances.
- Therefore, individual creditor's and debtor's accounts are opened in the total creditors' ledger and total debtors ledger and their summarized figures are posted in the respective Control Accounts in the General Ledger.

The principle described above can be illustrated as follows:

Take the example of Total Debtors Account:

Total of Opening Balances Dr.	Rs.	200,000
Add. Total of Debit entries	Rs.	<u>650,000</u>
		850,000
Less Total of Credit entries	Rs.	<u>(300,000)</u>
		650,000

The balance of Debtors control account in the general ledger should be Rs. 650,000. If this is not so, then there is an error in the procedure of recording, which should be traced out.

Information for Control Accounts – Debtors

In the above illustration, we used some information. Now we will study the sources from which the information is obtained.

Type of Information	Source of Information
Opening balance of debtors	List of debtors balances drawn up to the end of previous period.
Credit Sales	A separate book is maintained to record individual transactions. Totals are drawn from this book
Sales Return	A separate book is maintained to record individual transactions. Totals are drawn from this book
Cheques/Cash Received	List of receipts is extracted from cash and bank book.
Closing Balance	This is the balancing figure that can also be checked from the list of individual balance of debtors.

Consider the following data:

Sales Journal			
Date	Invoice #	Name	Amount
Jan, 20--		A	10,000
Jan, 20--		B	12,500
Jan, 20--		C	15,000
		Total	37,500

Total of sales journal will be recorded in the Debtors Control Account through the following entry:

Debit:	Debtors Control Account	37,500
Credit:	Sales Account	37,500

Note that cash sales are not included in this whole process. They are directly recorded in the general ledger.

Information for Control Accounts – Creditors

The information flow in case of creditors is similar to debtors, which is listed here:

Opening balance of debtors	List of creditors balances drawn up to the end of previous period.
Credit Purchases	A separate book is (purchase journal) is maintained to record individual transaction. Totals are drawn from this book
Purchase Return	A separate book is (purchase return journal) is maintained to record individual transaction. Totals are drawn from this book
Cheques/Cash Paid	List of payments is extracted from cash and bank book. Or a separate column is maintained in cash and bank books for this purpose.
Closing Balance	This is the balancing figure that can also be checked from the list of individual balance of debtors.

Consider the following data:

Purchase Journal			
Date	Invoice #	Name	Amount
Jan, 20--		X	5,500
Jan, 20--		Y	9,000
Jan, 20--		Z	8,500
		Total	23,000

Total of purchase journal will be recorded in the Creditors Control Account through the following entry:

Debit:	Purchases Account	23,500	
Credit:	Creditors Control Account		23,500

Note that cash purchases are not included in this whole process. They are directly recorded in the general ledger.

Example # 1

Prepare a Creditors Control Account from the following data and work out the closing balance on April 30, of creditors.

Apr. 1	Opening Balance	44,500
Totals for the month of May:		
	Total Credit Purchases	32,000
	Purchase Return	6,200
	Cheques and Cash paid	28,800
	Discounts received	2,500

Lesson-26**CONTROL ACCOUNTS (Continued)**

A number of books are opened in connection with control accounts to reduce the volume of general ledger. These books are called 'Subsidiary Books'.

It is important to note that only credit sales/purchases become part of control accounts. Cash sales/purchases are not included in the control accounts.

Subsidiary Books for Sales/Debtors

Three subsidiary books are maintained in case of sales / debtors.

- Sales Journal / Sales Day Book – individual invoice wise sales are recorded in this Journal. This book serves as source for all the recording of Credit sales.
- Sales Return / Return Inward Journal if volume of returns is also high then, these are also recorded in a separate register.
- Debtors Ledger – this ledger maintains record of individual debtor.

The information flows to the debtors control account in the general ledger as follows:

Opening balance of debtors	List of debtors balances drawn up to the end of previous period. This also confirms with the aggregate balance of the debtors ledger.
Credit Sales	Individual credit sale is recorded in the sales journal. Periodical total of this journal is posted into the debtors control account.
Sales Return	In case, the transaction volume of sales return is high, then these are recorded in the sales return journal. The total is posted in the debtors control account periodically.
Cheques / Cash Received	List of receipts is extracted from cash and bank book. Or a separate column is maintained in cash and bank books for this purpose.
Closing Balance	This is the balancing figure. It can also be checked with the total of balances in debtors' ledger.

Example # 1

Let's suppose that the sales journal provides the following record for the month of March, 2002:

Sales Journal			
Date	Invoice #	Name / Debtor	Amount
Mar 01, 2002	01	A	10,000
Mar 15, 2002	02	B	15,000
Mar 31, 2002	03	C	20,000
		Total	45,000

The above mentioned record will be posted in the personal ledger accounts of A, B & C (Debtors ledger account) in the following manner:

A's Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
01/03			10,000				
					Balance b/d		10,000
	Total		10,000		Total		10,000

B's Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
15/03			15,000				
					Balance b/d		15,000
	Total		15,000		Total		15,000

C's Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31/03			20,000				
					Balance b/d		20,000
	Total		20,000		Total		20,000

In the general ledger, the amount of total sales will be booked in the following manner:

Sales Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
				31/03	Total sales for the month of march, 2002		45,000
	Balance b/d		45,000				
	Total		45,000		Total		45,000

Debtors Control Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31/03	Total sales for the month of march, 2002		45,000				
					Balance b/d		45,000
	Total		45,000		Total		45,000

Now if we total the balance of three accounts of the debtors' ledger on Mar 31, 2002:

A	10,000
B	15,000
C	<u>20,000</u>
Total	<u>45,000</u>

It will be the same as the balance in the debtors control account of the general ledger.

Recording of Sales Return

Let's say that sales return journal for the month of March, 2002 give the following record:

Sales Journal			
Date		Name / Debtor	Amount
Jan 15, 20--		A	1,000
Jan 20, 20--		B	2,000
Jan 25, 20--		C	3,000
		Total	6,000

The above mentioned record will be posted in the personal ledger accounts of A, B & C (Debtors ledger account) in the following manner:

A's Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
01/03			10,000	15/03			1,000
					Balance b/d		9,000
	Total		10,000		Total		10,000

B's Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
15/03			15,000	20/03			2,000
					Balance b/d		13,000
	Total		15,000		Total		15,000

C's Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31/03			20,000	25/03			3,000
					Balance b/d		17,000
	Total		20,000		Total		20,000

In the general ledger, the amount of total sales return will be booked in the following manner:

Sales Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
	Total sales return for the month of march, 2002		6,000	31/03	Total sales for the month of march, 2002		45,000
	Balance b/d		39,000				
	Total		45,000		Total		45,000

Debtors Control Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31/03	Total sales for the month of march, 2002		45,000		Total sales return for the month of march, 2002		6,000
					Balance b/d		39,000
	Total		45,000		Total		45,000

Again if we total the balance of three accounts of the debtors' ledger on Mar 31, 2002:

A	9,000
B	13,000
C	<u>17,000</u>
Total	<u>39,000</u>

It will be the same as the balance in the debtors control account of the general ledger.

Receipts From Debtors

Here, we need a total figure of receipts from debtors. Therefore, when control accounts are used, we maintain cash and bank books with separate pages for receipts and payments i.e. two column cash/bank books are not used. On the receipts side of the cash and bank book, a column is added in which receipts from debtors are separately noted. This type of cash / bank book is also called multi column cash / bank book.

A sample of the receipt side of cash / bank book is given hereunder:

Cash / Bank Book					
Receipt Side					
Date	No	Narration / Particulars	Ledger Code	Receipt Amount	Receipt from Debtors
				10,000	
				500	
		Received from A		5,000	5,000

				300	
		Received from B		2,500	2,500
		Received from A		1,000	1,000
		Received from C		1,500	1,500
				950	
				1,000	
		Total		22,750	9,000

Subsidiary Books for Purchases/Creditors

Recording of creditors is similar to debtors. The subsidiary books maintained in case of purchases / creditors are:

- Purchase Journal / Purchase Day Book – individual purchases are recorded in this Journal.
- Purchase Return / Return outward Journal – If the volume of returns is also high, then these are also recorded in a separate register.
- Creditors Ledger – this ledger maintains record of individual creditors.

The information flows to the creditor control account in the general ledger as follows:

Opening balance of creditors	List of creditor balances drawn up to the end of previous period. This also confirms with the aggregate balance of the creditors ledger.
Credit Purchases	Individual credit purchase is recorded in the purchase journal. Total of this journal is posted into the creditors control account periodically.
Purchase Return	In case the transaction volume of purchase return is high, then, these are recorded in the purchase return journal. Periodically, the total is posted in the creditors control a/c.
Cheques / Cash Paid	List of payments is extracted from cash and bank book. Or a separate column is maintained in cash and bank books for this purpose.
Closing Balance	This is the balancing figure. It can also be checked with the total of balances in creditors' ledger.

Example # 2

Let's consider the following data for the month of March, 2002:

Purchase Journal			
Date		Name / Debtor	Amount
Mar 01, 2002		X	5,000
Mar 10, 2002		Y	10,000
Mar 25, 2002		Z	15,000
		Total	30,000

The above mentioned record will be posted in the personal ledger accounts of X, Y & Z (Creditors ledger account) in the following manner:

X's Account Account code----							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
	Balance b/d		5,000	01/03			5,000
	Total		5,000		Total		5,000

Y's Account Account code----							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
	Balance b/d		10,000	10/03			10,000
	Total		10,000		Total		10,000

Z's Account Account code----							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
	Balance b/d		15,000	25/03			15,000
	Total		15,000		Total		15,000

In the general ledger, the amount of total purchases will be booked in the following manner:

Purchases Account Account code----							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31/03	Total purchases for the month of march, 2002		30,000		Balance b/d		30,000
	Total		30,000		Total		30,000

Creditors Control Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31/03					Total purchases for the month of march, 2002		30,000
	Balance b/d		30,000				
	Total		30,000		Total		30,000

Now, if we total the balance of three accounts of the creditor's ledger on Mar 31, 2002:

X	5,000
Y	10,000
Z	<u>15,000</u>
Total	<u>30,000</u>

It will be the same as the balance in the creditors control account of the general ledger.

Recording of Purchase Return

Let's say that the purchase return journal show the following picture for the month of March, 2002:

Date	Name / Debtor	Amount
Mar 01, 2002	X	500
Mar 10, 2002	Y	1,000
Mar 25, 2002	Z	1,500
	Total	3,000

The above mentioned record will be posted in the personal ledger accounts of X, Y & Z (Creditors ledger account) in the following manner:

X's Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
01/03			500	01/03			5,000
	Balance b/d		4,500				
	Total		5,000		Total		5,000

Y's Account				Account code----			
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
10/03			1,000	10/03			10,000
	Balance b/d		9,000				
	Total		10,000		Total		10,000

Z's Account Account code----							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
25/03			1,500	25/03			15,000
	Balance b/d		13,500				
	Total		15,000		Total		15,000

In the general ledger, the amount of total purchases will be booked in the following manner:

Purchases Account Account code----							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31/03	Total purchases for the month of march, 2002		30,000	31/03	Total purchases return for the month of march, 2002		3,000
					Balance b/d		27,000
	Total		30,000		Total		30,000

Creditors Control Account Account code----							
Date	Particulars	Code #	Amount Rs. (Dr.)	Date	Particulars	Code #	Amount Rs. (Cr.)
31/03	Total purchases return for the month of march, 2002		3,000	31/03	Total purchases for the month of march, 2002		30,000
	Balance b/d		27,000				
	Total		30,000		Total		30,000

Now, if we total the balance of three accounts of the creditor's ledger on Mar 31, 2002:

X	4,500
Y	9,000
Z	<u>13,500</u>
Total	<u>27,000</u>

It will be the same as the balance in the creditors control account of the general ledger.

Payment to Creditors

Here, we need a total figure of payment to creditors. Therefore, when control accounts are used, we maintain cash and bank books with separate pages for receipts and payments i.e. two column cash/bank books are not used. On the payment side of the cash and bank book, a column is added in which payments to creditors are separately noted. This type of cash / bank book is also called multi column cash / bank book.

A sample of the payment side of cash / bank book is given hereunder:

Cash / Bank Book					
Payment Side					
Date	No	Narration / Particulars	Ledger Code	Payment Amount	Payment to Creditors
				500	
				5,000	
		Received from A		2,500	2,500
				3,000	
		Received from B		1,500	1,500
				1,000	
		Received from C		1,500	1,500
				1,950	
				1,500	
		Total		18,450	5,500

Lesson-27**CONTROL ACCOUNT (Continued)****A person is both debtor and creditor:**

This happens so many times in business that a person is both your debtor and creditor. This means that you are purchasing one thing from him. So, you have to pay him against that purchase and at the same time you are selling him another thing for which he has to pay you. For example, you purchase item X from Mr. A for Rs. 50,000 and sell him item Y for Rs. 25,000. Now, one way of settling the payable and receivable is that you can pay Mr. X 50,000 and ask him to pay you Rs. 25,000. The other and may be the wiser method is that you pay him Rs. 25,000 and both transactions are settled. This is how such transactions are handled in real life.

Journal Entries

Normally where no control accounts are maintained, following entries will be recorded:

Debit:	A (payable/creditor) account	25,000	
Credit:	A (receivable/debtor) account		25,000

- This will bring down the balance of A (receivable/debtor) account to 0 and that of A (payable/creditor) account to 25,000. The other entry will be:

Debit:	A (payable/creditor) account	25,000	
Credit:	Cash / Bank		25,000

- This will settle the payable account fully.

Where control accounts are being maintained the above two entries are still recorded but with slight modification:

Debit:	Creditors Control account	25,000	
Credit:	Debtors Control account		25,000

At the same time A's account in Creditor's ledger is debited with 25,000 and Credited in Debtors' ledger with the same amount.

Debit:	A (payable/creditor) account	25,000	
Credit:	Cash / Bank		25,000

This entry comes from the creditor's column of cash / bank book payment side as usual.

Bad Debts

Provision does not affect debtors account in simple books. It will, therefore, have no effect either on debtor control account or debtors ledger.

At the time of actual bad debt, the journal entry

Debit	Provision / Bad Debts
Credit	Individual Debtors Account

If control account system is in operation, the debit entry will be same but the credit effect will go to Debtors control account with a credit effect to Individual Debtors Account in Debtors Ledger.

Similar treatment is given to discounts received and allowed.

Recording Of Bad Debts in Control Accounts

To record bad debts in control accounts, following entries are recorded:

- In case no provision was created for doubtful debts:

Debit:	Bad Debts
Credit:	Debtors Control Account
- In case provision was created for doubtful debts:

Debit:	Provision for Doubtful Debts
Credit:	Debtors Control Account

Recording is also made in the respective accounts of the debtor in subsidiary ledger.

Recording of Discounts Received In Control Accounts

To record discount received in control accounts, following entry is recorded:

Debit:	Creditors Control Account
Credit:	Discount Received Account

Recording is also made in respective accounts of the creditors in subsidiary ledger.

Recording of Discounts Allowed In Control Accounts

To record discount allowed in control accounts, following entry is recorded:

Debit:	Discount Allowed Account
Credit:	Debtors Control Account

Recording is also made in the respective account of the debtors in subsidiary ledger.

Illustration # 1

Following information is given from the books of Mr. A (Debtor) for the month of June, 2002. You are required to prepare Debtors Control Account and work out the closing balance of debtors control account of Mr. A.

Opening Balance Dr.	85,500
<u>Transactions during the month:</u>	
Sales for the month	90,000
Sales return for the month	2,500
Payments received	140,000
Discount allowed	5,000
Bad debts written off	4,000

Solution

Debtors Control Account							
Debit Side				Credit Side			
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
Jun 01		Bal B/F	85,500	Jun		Returns	2,500
Jun		Sales	90,000	Jun		Receipts	140,000
				Jun		Discount allowed	5,000
						Bad Debts	4,000
				Jun 31		Bal C/F	24,000
		Total	175,500			Total	175,500

Illustration # 2

Following information is given from the books of Mr. B(Creditor) for the month of June, 2002. You are required to prepare Creditors Control Account and work out the closing balance of Creditors control account of Mr. B.

Opening Balance	Cr.	65,000
<u>Transactions during the month:</u>		
Purchases for the month		70,000
Purchases return for the month		5,000
Payments made		90,000
Discount received		3,000

Solution

Creditors Control Account							
Debit Side				Credit Side			
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
Jun		Returns	5,000	Jun 01		Bal B/F	65,000
Jun		Payments	90,000	Jun		Total purchases	70,000
Jun		Discounts received	3,000				
Jun 31		Bal C/F	37,000				
		Total	135,000			Total	135,000

Illustration # 3

The financial year of Atif Brothers is closed on June 30, 2002. You are required to prepare Debtors control account and Creditor control account from the data given below:

Opening balances

Debtors	150,000
Creditors	250,000

Sales

Cash	Note 1	180,000
Credit		260,000

Purchases

Cash	Note 1	120,000
Credit		200,000
Total receipts	Note 2	350,000
Total payments	Note 2	250,000
Discount allowed		15,000

Discount received		10,000
Bad debts written off		25,000
Increase in provision for doubtful debts	Note 3	5,000

Solution

Debtors Control Account							
Debit Side				Credit Side			
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
Jun 01		Bal B/F	150,000	Jun		Receipts(N2)	170,000
Jun		Sales(N1)	260,000	Jun		Discount allowed	15,000
						Bad Debts	25,000
				Jun 31		Bal C/F	200,000
		Total	410,000			Total	410,000

Creditors Control Account							
Debit Side				Credit Side			
Date	No.	Narration	Dr. Rs.	Date	No.	Narration	Cr. Rs.
Jun		Payments	130,000	Jun 01		Bal B/F	250,000
Jun		Discounts received	10,000	Jun		Total purchases	200,000
Jun 31		Bal C/F	310,000				
		Total	450,000			Total	450,000

Notes to the accounts:

- In control accounts, only cash sales/purchases are dealt with. Credit sales/purchases are not included in control accounts,
- Receipts/Payments include both cash and credit receipts/payments. So, we enter the figures in control accounts, after deducting cash sales/purchases from total receipts/payments. i. e.

$$\text{Receipts} = 350,000 - 180,000 = 170,000$$

$$\text{Payments} = 250,000 - 120,000 = 130,000$$

- Provision for doubtful debts has no effect on control accounts. So, any change in provision will not affect actual bad debts.

Benefits of Subsidiary Ledgers

- Subsidiary ledgers contain the record of all individuals Debtors and Creditors.
- Subsidiary ledgers give information about the main clients and slow moving clients which is helpful for the management in decision making.
- If the business has distributors in different areas, subsidiary ledger gives information about sale of different distributors in different areas which are helpful for the management in decision making.

Lesson-28**RECTIFICATION OF ERROR**

In financial accounting, every single event occurring in monetary terms is recorded. Sometimes, it just so happens that some events are either not recorded or it is recorded in the wrong head of account or wrong figure is recorded in the correct head of account.

Whatever the reason may be, there is always a chance of error in the books of accounts. These errors in accounting require rectification. The procedure adopted to rectify errors in financial accounting is called “**Rectification of error**”.

How to rectify these errors?

One way of rectification is that we can simply erase or overwrite the incorrect entry and replace it with the correct one. But this practice is not allowed in accounting. We have to Rectify / correct the mistake by recording another entry.

Types of Errors

Before going to the rectification process, let’s first see the different kinds of errors that can appear in our books of accounts:

Error of Omission

One of the most common errors is that an event escapes recording. This means that an event occurred but we did not record it. For example, we discussed about bank charges being deducted by banks without our knowledge or our payments made by banks on our standing orders etc. There can be other reasons as well. Such errors are called ERRORS OF OMISSION.

Error of Commission

Then, there is a chance that the event is classified and recorded correctly but within wrong classification of account. For example, a payment to Mr. A, who is a debtor, is recorded in the account of Mr. B, who is also a debtor. Now the classification is correct but entry is posted in the wrong account. Such errors are called ERRORS OF COMMISSION.

Error of Principle

Then there are errors in which an entry is recorded in the wrong class of account. For example a purchase of fixed asset, say, a vehicle is recorded in an expense account. These errors are called ERRORS OF PRINCIPLE.

Error of Original Entry

The errors in which recording is in correct account but the figure is incorrect are called ERRORS OF ORIGINAL ENTRY. For example, a receipt of Rs. 50,000 from a debtor is recorded as Rs. 5,000 in his account.

Reversal of Entry

Then, there are errors in which the entry is reversed by mistake. This means that the account that should have been debited is credited and vice versa. These errors are called REVERSAL OF ENTRY.

Rectifying the Errors

Now, we will rectify all these types of entries:

Error of Omission

This is the easiest error to rectify. You have to record the entry that was omitted by mistake. It is important to note here that the rectifying entry will be posted on the date on which the error was discovered. But we will give a note in the narration of the voucher that the event took place on such date.

Example:

A purchase of Rs. 5,000 from ABC on April 15 was omitted by mistake.

Rectifying Entry on the date of discovery:

Debit:	Purchase Account	15,000	
Credit:	ABC Account		15,000

Narration: Rectification of omission of recording purchase to ABC on April 15.

Errors of Commission / Error of Principle

In both these cases, the effect given to incorrect account is reversed and effect is given to the correct account.

Example:

Purchase of an asset for Rs. 50,000 is recorded in the expense account.

Rectification:

Debit:	Asset Account	50,000	
Credit:	Relevant Expense Account		50,000

Narration: Rectification of purchase of asset incorrectly recorded as expense.

Error of Original Entry

If the entry recorded is of lesser amount than the required amount, then an entry of the balance amount is passed. On the other hand, if the entry recorded is of a greater amount than the required amount, a reverse entry is passed of the balance amount that cancels the effect of the error.

Example

- 1) A receipt of cash Rs. 5,000 from B is recorded as Rs. 500
- 2) A receipt of cash Rs. 5,000 from B is recorded as Rs. 50,000

Rectification

In the first instance, the recorded figure is less by Rs. 4,500. The rectification entry will, therefore, be:

Debit:	Cash Account	4,500	
Credit:	B Account		4,500

In the second instance, the recorded figure exceeds by Rs. 45,000 from the desired figure. The rectification will, therefore, be a reverse entry of Rs. 45,000:

Debit:	B Account	45,000	
Credit:	Cash Account		45,000

Reversal of Entry

If a reverse entry is recorded by mistake, then two entries are required to rectify it, one to reverse the effect of mistake and the other to record correct entry or we can pass one entry with double amount that serves the purpose of both the entries.

Example:

A payment of Rs. 10,000 made to Mr. D is recorded on the receipt side of the cash book and credit is given to D's account.

Rectification

We can correct this mistake by two entries:

Debit:	Mr. D Account	10,000	
Credit:	Cash Account		10,000

This will reverse the effect of mistake:

Debit:	Mr. D Account	10,000	
Credit:	Cash Account		10,000

And this will record the transaction correctly:

Or

We can record it through one entry:

Debit:	Mr. D Account	20,000	
Credit:	Cash Account		20,000

Based on our above discussion, we can devise a general procedure for rectification of errors.

Take another example, assume that we received cash Rs. of 50,000 from a debtor and instead of Debiting the Cash Book / Cash Account, we debited the Bank Book whereas the credit was given to the correct account.

Step 1: Note down the correct entry

Debit	Cash	50,000	
Credit	Creditors		50,000

Step 2: Note down the incorrect entry

Debit	Bank	50,000	
Credit	Creditors		50,000

Step 3: See that Credit affect is correct. In case of Debit, affect has been given to Bank instead of cash. Therefore we will give the due affect to Cash by debiting it and Remove the incorrect affect from bank by crediting it.

Debit	Cash Account	50,000	
Credit	Bank Account		50,000

Illustration

Rectify the following errors:

1. A cheque issued of Rs. 50,000 to Mr. A (Creditor), but the credit was given to cash account.
2. Purchase of goods from Mr. B worth of Rs. 5,500 was recorded at Rs. 4,500.
3. Cash sale to Mr. C worth of Rs. 10,000 was debited to sale account and credited to cash account.
4. Repair of vehicle worth of Rs. 5,000 was charged to asset account.
5. A cheque of Rs. 15,000 received and deposited in bank from Mr. D, but no entry was passed.

Solution**Entry # 1**

Correct Entry

Debit:	Mr. A (Creditor) A/C	50,000	
Credit:	Bank A/C		50,000

Incorrect Entry passed

Debit:	Mr. A (Creditor) A/C	50,000	
Credit:	Cash A/C		50,000

Rectifying Entry

Debit:	Cash A/C	50,000	
Credit:	Bank A/C		50,000

Entry # 2

Correct Entry

Debit:	Purchase A/C	5,500	
Credit:	Mr. B's A/C		5,500

Incorrect Entry passed

Debit:	Purchase A/C	4,500	
Credit:	Mr. B's A/C		4,500

Rectifying Entry

Debit:	Purchase A/C	1,000	
Credit:	Mr. B's A/C		1,000

Entry # 3

Correct Entry

Debit:	Cash	10,000	
Credit:	Sale A/C		10,000

Incorrect Entry passed

Debit:	Sale A/C	10,000	
Credit:	Cash		10,000

Rectifying Entry

Debit:	Cash	20,000	
Credit:	Sale A/C		20,000

Entry # 4

Correct Entry

Debit:	Repair A/C	5,000	
Credit:	Cash A/C		5,000

Incorrect Entry passed

Debit:	Asset (vehicle) A/C	5,000	
Credit:	Cash A/C		5,000

Rectifying Entry			
Debit:	Repair A/C	5,000	
Credit:	Asset (vehicle) A/C		5,000

Entry # 5

Correct Entry			
Debit:	Bank A/C	15,000	
Credit:	Mr. D's A/C		15,000

Incorrect Entry passed

No entry was passed

Rectifying Entry			
Debit:	Bank A/C	15,000	
Credit:	Mr. D's A/C		15,000

Lesson-29**PRESENTATION OF FINANCIAL STATEMENTS****Profit & Loss Account**

Standard format of profit & loss account is shown as follows:

Particulars	Amount Rs.	Amount Rs.
Sales		X
Less: Cost of Goods Sold		(x)
Gross Profit		X
Less: Administrative Expenses		
Selling Expenses	X	
	X	(x)
Operating Profit		X
Less: Financial Expenses		(x)
Add : Other income		
Profit Before Tax		X
Less: Tax		(x)
Net Profit After Tax for the Year		X
<u>Other income</u>		

Sales

Sales as we know are the revenue against the sale of the product in which the organization deals. In case of a service organization, there will be Income against Services Rendered instead of Sales and there will be no Cost of Sales or Gross Profit.

Cost of Goods Sold/Gross Profit

Cost of goods sold is the cost incurred in purchasing or manufacturing the product, which an organization is selling plus any other expense incurred in bringing the product in salable condition. Cost of goods sold contains the following heads of accounts:

- Purchase of raw material/goods
- Wages paid to employees for manufacturing of goods
- Any tax/freight is paid on purchases
- Any expense incurred on carriage/transportation of purchased items.

$$\text{Gross Profit} = \text{Sales} - \text{Cost of goods sold}$$

Other Income

Other income includes revenue from indirect source of income, such as return on investment, profit on PLS account etc.

Administrative Expenses

Administrative expenses are the expenses incurred in running a business effectively. Main components of this group are:

- Payment of utility bills
- Payment of rent
- Salaries of employees
- General office expenses
- Repair & maintenance of office equipment & vehicles.

It is important to distribute expenses properly among the three classifications i.e. Cost of Goods Sold, Administrative Expenses and Selling Expenses to present the financial statements fairly. Take the example of following costs:

- **Salaries and Wages**

- Although both these terms mean remuneration paid to labor and employee against services.
- Wages usually denotes remuneration paid to daily wages labor. Whereas salary denotes payments to permanent employees.
- Salaries can be classified in any of the classifications mentioned below.
 - Salaries / wages paid to labor and supervisors/officers working for the manufacturing of goods become a part of Cost of Goods Sold.
 - Salaries and benefits of general administrative staff becomes part of Administrative Expenses
 - Salaries and benefits of sales and marketing staff become part of selling expenses.

Other expenses like Depreciation, Utilities and Maintenance can also be classified in all three, depending upon the exact nature of the expenditure.

Selling Expenses

Selling expenses are the expenses incurred directly in connection with the sale of goods. This head contains:

- Transportation/carriage of goods sold
- Tax/freight paid on sale

If the expense head 'salaries' includes salaries of sales staff, it will be excluded from salaries & appear under the heading of 'selling expenses'.

Financial Expenses

Financial expenses are the interest paid on bank loan & charges deducted by bank on entity's bank accounts. These are shown separately in the Profit and Loss Account. These include:

- Interest on loan
- Bank charges

There is, however, one exception and that is the interest paid on loan taken to build an asset is capitalized as cost of the asset up to the time that asset is completed.

Income Tax

Different types of entities have to pay income tax at different rates. At the time of preparing annual financial statements, an estimate of expected tax liability is made. A provision is then, created equal to that estimate.

You should remember the treatment of Provision for Doubtful debts. Same is the case with income tax i.e. provision is made at the time of preparing accounts which is then adjusted accordingly at the time when actual tax expense is known.

Balance Sheet (Asset Side)

Standard format of the balance sheet is given as follows:

Particulars	Amount Rs.	Amount Rs.
<u>Assets</u>		
Non Current Assets		
Fixed Assets		X
Capital Work In Progress		X
Deferred Costs		X
Long Term Investments		X
Current Assets		
Stocks	X	
Trade debtors and Other Receivables	X	
Prepayments	X	
Short Term Investments	X	
Cash and Bank	X	
Total	X	X

Fixed Assets

- Fixed assets are the assets of permanent nature that a business acquires, such as plant, machinery, building, furniture, vehicles etc.
- Fixed assets are presented at cost less accumulated depreciation OR revalued amount.

Capital Work In Progress

If an asset is not completed at that time when balance sheet is prepared, all costs incurred on that asset up to the balance sheet date are transferred to an account called **Capital Work in Progress Account**. This account is shown separately in the balance sheet below the fixed assets. Capital work in progress account contains all expenses incurred on the asset until it is converted into working condition. All these expenses will become part of the cost of that asset. When an asset is completed and it is ready to work, all costs will transfer to the relevant asset account.

Deferred Costs

An expense that has a future benefit in excess of one year and recorded in a capital asset account

Long Term and Short Term Investments

Where a business has surplus funds, it is better to invest those funds where these can generate a return greater than PLS accounts. These investments can be of different types e.g. shares of other companies, fixed deposits with banks, government securities, national savings etc. or presentation purposes, these Investments are classified in two categories, long term and short term investments. Investments made with the intention that they will be held for a period longer than twelve months are classified as long term and those made for a period equal to or shorter than 12 months are classified as short term.

Following things are important to note here:

- Classification is to be made every time a balance sheet is prepared and the period is to be calculated from the date of balance sheet.

- This means that an investment made for 2 years on May 2000 will be classified as long term investment in accounts prepared on Jun 30, 2000 and the same investment will be classified as current investment in the accounts prepared on June 30, 2001.
- An investment may initially be made as current investment. Subsequently, if it is decided to hold it for a longer period, then its classification will have to be changed accordingly and vice versa.
- Therefore, investments are checked for classification every time a balance sheet is prepared and presented accordingly.

Current Assets

Current Assets are the receivables that are expected to be received within one year of the balance sheet date. Debtors, closing stock & all accrued incomes are the examples of Current Assets because these are expected to be received within one accounting period from the balance sheet date.

It is important to note that assets and liabilities are presented in the balance sheet in the order of their maturity i.e. assets / liabilities having longer life are presented first and assets / liabilities having shorter life are presented later.

Lesson-30**PRESENTATION OF FINANCIAL STATEMENTS (Continued)****Standard Format of Balance Sheet (Liability Side)**

Particulars	Amount Rs.	Amount Rs.
<u>Liabilities</u>		
Capital and Reserves		
Capital	X	
Reserves	X	
Profit and Loss Account	X	X
Non Current / Long Term Liabilities		
Long term loans	X	
Other long term liabilities	X	X
Current Liabilities		
Trade creditors and other payables	X	
Short term borrowings	X	
Current portion of long term borrowings	X	X
Total		X

Capital

Capital is the first item shown on the liability side of the balance sheet of an organization. **Capital** is the Money invested in the business by the owners. Capital is a liability for the business as the business has to pay return against this money and in case the business is closed, then it has to return the amount. Capital is also termed as "Share Capital".

Recording of Capital

Recording of Capital is Simple.

- At the time of receipt

Debit	Cash / Bank
Credit	Capital
- If the owner contributes an asset instead of cash, then

Debit	Asset Account
Credit	Capital
- When the capital is repaid (this does not happen in normal course of business, but just in case)

Debit	Capital
Credit	Cash / Bank

Reserves

The portion of profit which is not paid to proprietor, but is kept apart for meeting some known or unknown losses is called Reserve, e.g. Reserve fund, contingencies reserve etc.

There are two major types of reserves:

Revenue Reserves

From the view point of its creation revenue reserve may again be classified into:

a. General reserve

Reserve which is not created for any specific purpose, but for strengthening the financial position of the business is known as General Reserve, e.g. Reserve fund, contingencies reserve etc.

b. Specific Reserve

Reserve created for any special purpose is known as Specific Reserve. e.g., Dividend Equalization fund, Debenture sinking fund etc.

Capital Reserves

Capital reserves, in most of the cases, are created due to legal requirements. Profit may arise from sources, other than normal business activity. For example, profit on sale of fixed assets or profit on revaluation of fixed assets. When a reserve is created out of these profits, it is termed as capital reserve. One capital reserve about which we already know is “Fixed Assets Revaluation Reserve”. Capital reserves can be used for specific purposes only.

Difference between Reserve And Provision

Both reserves and provisions are created out of revenues of the business, but they differ from each other.

- Creating a provision is necessary to show a true profit for the period, whereas the reserve is created on the discretion of the owner, out of profits.
- Provision is to be made, even, if there is a loss; Reserves are created out of profits only.
- Reserve is shown as liability in the balance sheet, Provision is shown as a reduction from the asset against which it is created.
- Provision is used specifically for the purpose for which it is made, Reserves are usually general and can be used for any purpose.

Profit And Loss Account

Profit and Loss Account or Accumulated Profit and Loss Account shows the balance of un-distributed profit accumulated over the periods. In the first year of business, this account shows following figure:

Profits for the year	X
Less: Transferred to Reserve	(X)
Less: Profit distributed	(X)
Balance carried to Balance Sheet	<u>X</u>

In Subsequent years, balance brought forward from previous years and profit for the year is added and distributed as above and the balance is carried to next year. This is why; it is termed as Accumulated Profit and Loss Account.

Long Term Loans

The owners of the business may feel that their business can flourish, if there are more funds. These funds can be arranged from their own resources, if possible, or they can ask a bank or financial institution for funds. This loan, if extended by bank for a period of more than one year is termed as a long term loan. There can be other sources of long term loans as well, e.g. Term Finance Certificates and Debentures, where money is borrowed from general public under certain legal restrictions.

Other Long Term Liabilities

These include all other liabilities that are payable after a period of one year of balance sheet date. For example, staff gratuity and other benefits, taxes and liabilities that become payable after a period of one year.

Current Liabilities

Current Liabilities are the obligations of the business that are payable within twelve months of the balance sheet date. Creditors, all accrued expenses are the examples of current liabilities of the business because business is expected to pay these back within one accounting period.

Current Portion of Long Term Liabilities

Long term loans are usually payable in installments. Therefore, at the end of every year, some portion of the loan becomes payable within one year of the balance sheet date. The portion that becomes payable within the next accounting period is transferred to current liabilities and classified under current portion of long term liabilities.

Format of current liabilities shown in the balance sheet is as follows:

Current Liabilities

- Trade Creditors
- Short Term Borrowings
- Other Short Term Liabilities
 - Salaries Payable
 - Accrued Expenses
 - Bills payable
 - Advances from Customers

Lesson-31**TYPE OF BUSINESS ENTITIES**

There are two types of entities:

- Commercial organizations
- Non-commercial organizations

Commercial Organization

Commercial organization is the entity that is working to earn profit. At the end of the financial year, the profit is distributed among the owners of the business. Normally, commercial organizations include:

- Sole proprietorship
- Partnership, and
- Limited Company

Non Commercial Organization

Non Commercial organization is the entity that is not working to earn profit. At the end of the financial year, the profit is not distributed among the owners, but is used for the objective of the organization. Normally, commercial organizations include:

- Co-Operative institutions
- NGO's
- Trusts

Types of Commercial Organization**Sole proprietorship business**

It is a business that is owned by an individual. He may have employed any number of persons to work for him, but he is the sole owner of the business.

Partnership

Partnership is the type of business where more than one person (called partners) enters into a legal agreement to run a business on a profit and loss sharing basis.

Limited Company

Limited company is a legal entity, separate from its owners (called shareholders). The basic difference between a partnership and a limited company is the concept of limited liability.

- If a partnership business runs into losses and is unable to pay its liabilities, its partners will have to pay the liabilities from their own wealth.
- Whereas, in case of limited company, the shareholders don't lose anything more than the amount of capital they have contributed in the company. i.e., their personal wealth is not at stake and their liability is limited to the amount of share capital they have contributed.

The concept of limited company is to mobilize the resources of a large number of people for a project, which they would not be able to afford independently and then, get it managed by experts.

Accounting Requirements**Sole Proprietorship**

In case of sole proprietor, owner is the sole owner of the business. So, there is no restriction on him for drawing money for his personal use.

For accounting purposes, an account titled Proprietor's Drawings is opened in the General Ledger and all payments and receipts, if any, from the proprietor are recorded in this account.

Accounting Entries

Cash Drawn by Proprietor:

Debit	Proprietor's drawing
Credit	Cash

Amount paid in by proprietor through cheque:

Debit	Bank
Credit	Proprietor's drawing

The balance in drawings account is transferred to Capital Account at the year end.

The sample of general ledger of Capital account, in case of profit earned by the business, is as follows:

Capital Account							
Debit Side				Credit Side			
Date	No	Narration	Dr. Rs.	Date	No	Narration	Cr. Rs.
Jun 30		Drawings a/c	45,000	Jul 01		Balance B/F	100,000
				Jun 30		P & L Account	50,000
Jun 30		Balance C/F	105,000				
		Total	150,000			Total	150,000

The sample of general ledger of Capital account, in case of loss sustained by the business, is as follows:

Capital Account							
Debit Side				Credit Side			
Date	No	Narration	Dr. Rs.	Date	No	Narration	Cr. Rs.
Jun 30		P & L Account	10,000	Jul 01		Balance B/F	100,000
Jun 30		Drawings	45,000				
Jun 30		Balance C/F	45,000				
		Total	100,000			Total	100,000

The balance sheet of sole proprietor is as follows:

Name of Business		
Balance Sheet As At ----		
Particulars	Amount Rs.	Amount Rs.
Assets		
Fixed Assets		X
Long Term Assets		X
Current Assets		X
Total		X
Liabilities		
Capital	X	
Add: Profit / Loss For The Year	X	
Less: Drawings	(X)	X
Long Term Liabilities		X
Current Liabilities		X
Total		X

Partnership

There are two types of capital accounts in partnership:

- Fixed capital
- Fluctuating capital

Fixed Capital

In this case, capital account shows movement in capital account only i.e. actual increase or decrease in capital, by partners and all other transactions, such as Drawings and Profit etc. are not recorded in capital account.

Fluctuating capital

In fluctuating capital account, all transactions relating to partners, such as drawings, salaries etc. are recorded in capital account, in addition to entries relating to capital account.

Current Account

In case of fixed capital accounts, other transactions such as Drawings and Profit etc. are recorded in a separate account called Current Account.

Journal Entries

Capital Introduced by Partner:

Debit	Cash / Bank
Credit	Partner's Capital Account

Separate capital account is opened in general ledger for each partner.

Drawing by Partner:

Debit	Individual Partner's Current Account
Credit	Cash / Bank

Excess Drawn Amount Returned by Partner:

Debit	Bank / cash
Credit	Individual Partner's Current Account

Profit Distribution:

Debit	Profit and Loss Appropriation Account
Credit	Partner A's Current Account
Credit	Partner B's Current Account
Credit	Partner C's Current Account

Balance Sheet of Partnership Accounts

Name of Business			
Balance Sheet			
As At ----			
Particulars		Amount Rs.	Amount Rs.
ASSETS			
Fixed Assets			X
Long Term Assets			X
Current Assets			X
Total			X
Liabilities			
Capital	A	X	
	B	X	
	C	X	X
Current Account	A	X	
	B	X	
	C	X	X
Long Term Liabilities			X
Current Liabilities			X
Total			X

Limited Companies

There are two types of companies:

- Public Limited Companies
- Private Limited Companies

Public Limited Companies

In public limited companies, there is no restriction on number of persons to be its members. There is one restriction. i.e., there should be a minimum of **three** members to form a public limited company.

Private Limited Companies

Two to fifty persons can form a private limited company. Minimum two members are elected to form a board of directors. This board is given the responsibility to run day to day business of the company.

Share Capital

Capital of the company is divided into small units / denominations. These units / denominations are called shares and the capital is called share capital. Owners purchase these shares and are, therefore, called shareholders. As, there are so many shareholders in a company, profit is distributed among the members/shareholders of the company on the basis of number of shares held by each shareholder. The profit distributed among shareholders is called **DIVIDEND**.

Lesson-32**FINANCIAL STATEMENTS OF SOLE PROPRIETORSHIP****Illustration # 1**

Prepare profit & loss account and balance sheet for the year ending June 30, 2002 from the following trial balance of Naseem Trading Company.

Particulars	Debit Rs.	Credit Rs.
Opening Stock	115,200	
Cash in hand	10,800	
Cash at bank	52,600	
Purchases	813,500	
Returns inward (Sales return)	13,600	
Wages	169,600	
Fuel & power	94,600	
Carriage on sales	64,000	
Carriage on purchases	40,800	
Building	640,000	
Land	200,000	
Machinery	400,000	
Salaries	300,000	
General expenses	60,000	
Drawings	12,000	
Insurance	104,900	
Sundry Debtors	290,000	
Sales		1,975,600
Returns outwards (Purchase returns)		10,000
Capital		1,090,000
Sundry Creditors		126,000
Rent received		180,000
Total	3,381,600	3,381,600

Following additional information is supplied to you:

- Closing stock is valued at Rs. 136,000
- Machinery & Building are to be depreciated @ 10%
- Salaries for the month of June, 2002 amounting to Rs. 30,000 are unpaid
- Insurance is paid in advance to the extent of Rs. 13,000
- Rent receivable is Rs. 20,000

Solution

When additional information is given at the end of the question, which means these entries are still to be recorded in the books of accounts. So, we shall pass the entries first:

Entry # 1

Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Closing stock account		136,000	
Profit & Loss account			136,000
Closing stock is recorded			

Closing stock is presented in the profit & loss account, credited in the cost of goods sold and is shown in the balance sheet under the heading of Current Assets.

The ledger account of closing stock will be as follows:

Stock Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Closing Stock	136,000		
		Balance b/d	136,000
Total	136,000	Total	136,000

Entry # 2

Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Depreciation account		40,000	
Machinery account			40,000
Depreciation on machinery is charged.			

Depreciation of machinery will be shown in the profit & loss account under the heading of Administrative Expenses and will be deducted from the value of machinery account in the balance sheet.

Entry # 2

Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Depreciation account		64,000	
Building account			64,000
Depreciation on building is charged.			

Depreciation of building will be shown in the profit & loss account under the heading of Administrative Expenses and will be deducted from the value of building account in the balance sheet.

The ledger account of depreciation will be as follows:

Depreciation Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Dep. of Machinery	40,000		
Dep. of building	64,000		
		Balance b/d	104,000
Total	104,000	Total	104,000

Entry # 3

Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Salaries account		30,000	
Salaries payable account			30,000
Salaries for the month of June are unpaid.			

Salaries account will be presented in the profit & loss account under the heading of Administrative Expenses and salaries payable will be presented in the balance sheet under the heading of Current Liabilities.

The ledger account of salaries will be as follows:

Salaries Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Balance c/d	300,000		
Salaries payable	30,000		
		Balance b/d	330,000
Total	330,000	Total	330,000

Entry # 4

Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Advance Insurance		13,000	
Insurance Account			13,000
Insurance is paid in advance			

Advance insurance is our asset and it will be shown in the balance sheet under the heading of current assets and advance insurance will be deducted from the insurance expenses.

The ledger account of insurance will be as follows:

Insurance Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Balance c/d	104,900	Advance insurance	13,000
		Balance b/d	91,900
Total	104,900	Total	104,900

Entry # 5

Particulars	Code #	Amount(Dr.) Rs.	Amount(Cr.) Rs.
Rent Receivables		20,000	
Rental Income			20,000
Rental Income receivable			

Rent receivables is our income and it will be shown in the balance sheet under the heading of current assets and rent will be shown as income in the profit & loss account

The ledger account of rent will be as follows:

<i>Rent Account</i>		<i>Account Code -----</i>	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
		Balance c/d Receivable	180,000 20,000
Balance b/d	200,000		
Total	200,000	Total	200,000

Profit & Loss Account

Naseem Trading Company		
Profit & Loss Account		
For the year ended June 30, 2002		
Particulars	Amount Rs.	Amount Rs.
Income / Sales / Revenue	1,975,600	
Less: Sales Return	(13,600)	1,962,000
Less: Cost of Goods Sold (See note # 1)		1,087,700
Gross Profit		874,300
Less: Administrative expenses (See note # 2)		585,900
Less: Selling Expenses Carriage on sales		64,000
Operating profit		224,400
Add: Other Income (Rent received)		200,000
Net Income		424,400

Note # 1 Cost of Goods Sold

	Rs.
Opening stock	115,200
Add: Purchases	813,500
Less: purchase return	(10,000)
Add: Carriage on purchases	40,800
Add: Wages	169,600
Add: Fuel and power	94,600
Less: Closing stock	(136,000)
Cost of goods sold	1,087,700

Note # 2 Administrative Expenses

General expenses	60,000
Insurance	91,900
Depreciation on Machinery	40,000
Depreciation on Building	64,000
Salaries	330,000
Total Administrative Expenses	585,900

Balance Sheet

Naseem Trading Company			
Balance Sheet			
As At June 30, 2002			
Liabilities		Assets	
Particulars	Amount Rs.	Particulars	Amount Rs.
Capital	1,090,000	Fixed Assets	
Add: Profit and Loss	424,400	land	200,000
Account	(12,000)	Machinery	360,000
Less: Drawings		Less: Dep. (40,000)	
		Building 640,000	576,000
		Less: Dep. (64,000)	
	1,502,400		1,136,000
Current Liabilities		Current Assets	
Creditors	126,000	Debtors	290,000
Salaries payable	30,000	Cash in hand	10,800
		Cash at bank	52,600
		Closing stock	136,000
		Rant receivable	20,000
		Advance insurance	13,000
Total	1,658,400	Total	1,658,400

Illustration # 2

Following trial balance has been extracted from the books of Arif Traders on June 30, 2002

Arif Traders		
Trial balance		
As on June 30, 2002		
Particulars	Amount Dr. (Rs.)	Amount Cr. (Rs.)
Sales		987,000
Stock on June 30,2002	175,500	
Material Consumed	537,000	
Cash in Hand	10,500	
Cash at Bank	57,000	
Capital Account July 01, 2001		495,000
Drawings	142,500	
Furniture	72,000	
Rent Paid	51,000	
Wages Paid	129,000	
Discounts Allowed	34,500	
Discounts Received		18,000
Debtors	246,000	
Creditors		124,500
Provision for Doubtful Debts Jul. 01 2001		13,500
Vehicles	120,000	
Vehicle Running Costs	22,500	
Bad Debts Written off	40,500	
Total	1,638,000	1,638,000

Further information available:

- Wages and salaries payable on June 30, 2002 Rs. 4,500
- Rent prepaid on June 30, 2002 Rs. 7,000
- Vehicle running costs payable on June 30 Rs. 3,000
- Increase in provision for doubtful debts Rs. 3,000
- Depreciation rate is 12.5% for furniture and 20% for vehicle.

You are required to prepare Profit and Loss Account for the year and Balance Sheet as on June 30, 2002

Solution

Arif Traders,		
Profit and Loss Account,		
For the Year Ending June 30, 2002		
Particulars	Rs.	Rs.
Sales		987,000
Less: Cost of Goods Sold (material consumed)		(537,000)
Gross Profit		450,000
Less: Expenses		
Wages and Salaries	Note 1 (133,500)	
Rent	Note 2 (44,000)	
Discount Allowed	(34,500)	
Vehicle Running Cost	Note 3 (25,500)	
Provision for Doubtful Debt	Note 4 (43,500)	
Depreciation	Note 5 (33,000)	(314,000)
Operating profit		136000
Add: Other income(Discount receive)		18,000
Net Income		154,000

In the profit & loss account prepared above, the amount of bad debts written off are grouped with the provision for doubtful debts (see note # 4)

In the following presentation, bad debts are shown separately and working of provision of bad debts is shown in Note # 4(a).

Arif Traders,		
Profit and Loss Account,		
For the Year Ending June 30, 2002.		
Particulars	Rs.	Rs.
Sales		987,000
Less: Cost of Goods Sold		(537,000)
Gross Profit		450,000
Less: Expenses		
Wages and Salaries	Note 1 (133,500)	
Rent	Note 2 (44,000)	
Discount Allowed	(34,500)	
Vehicle Running Cost	Note 3 (25,500)	
Bad Debts	(40,500)	
Provision for Doubtful Debt	Note 4(a) (3,000)	(314,000)
Depreciation	Note 5 (33,000)	
Operating Profit		136000
Add: Other income(Discount receive)		18000
Net Income		154000

Arif Traders		
Balance Sheet		
As At June 30, 2002		
Particulars	Amount Rs.	Amount Rs.
Assets		
Fixed Assets Note 5		159,000
Current Assets		
Stocks	175,500	
Debtors Note 6	229,500	
Prepaid Expenses	7,000	
Cash at Bank	57,000	
Cash in Hand	10,500	
		479,500
Total		638,500
Liabilities		
Capital	495,000	
Profit	154,000	
Less: Drawings	(142,500)	
		506,500
Current Liabilities		
Creditors	124,500	
Expenses Payable Note 7	7,500	
		132,000
Total		638,500

Note # 1 Salaries & Wages account

Salaries & Wages		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Salaries & Wages Paid	129,000		
Salaries & Wages Payable	4,500		
		Transfer to Profit & Loss Account	133,500
Total	133,500	Total	133,500

Note # 2 Rent account

Salaries & Wages		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Rent Paid	51,000		
		Rent Payable	7,000
		Transfer to Profit & Loss Account	44,000
Total	51,000	Total	51,000

Note # 3 Vehicle running cost account

Vehicle Running cost		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Cost Paid	22,500		
Cost Payable	3,000		
		Transfer to Profit & Loss Account	25,500
Total	25,500	Total	133,500

Note # 4 Provisions for doubtful debts account

Provision for doubtful debts		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Bad Debts	40,500	Balance B/F	13,500
Balance C/F	16,500	Transfer to Profit & Loss Account	43,500
Total	57,000	Total	57,000

Note # 4 (a) Provision for doubtful debts account

Provision for doubtful debts		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
		Balance B/F	13,500
Balance C/F	16,500	Transfer to Profit & Loss Account	3,000
Total	16,500	Total	16,500

Note # 5 Fixed Assets at WDV

	<u>Cost</u>	<u>Rate</u>	<u>Dep.</u>	<u>WDV</u>
Furniture	72,000	12.5%	9,000	63,000
Vehicle	120,000	20%	<u>24,000</u>	<u>96,000</u>
			33,000	159,000

Note # 6 Debtors account

Debtors	246,000
Less: Provision for Doubtful Debts (note 4)	<u>(16,500)</u>
	<u>229,500</u>

Note # 7 Expenses Payable

Expenses Payable		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
		Salaries	4,500
		Vehicle running cost	3,000
Balance C/F	7,500		
Total	7,500	Total	7,500

Lesson-33**FINANCIAL STATEMENTS OF MANUFACTURING CONCERN**

In this lecture, we will discuss financial statements of manufacturing concern. In manufacturing concern, cost of goods sold statement is also prepared.

Illustration #1

Following trial balance has been extracted from the books of Hassan Manufacturing Concern on June 30, 2002.

Hassan Manufacturing Concern		
Trial balance		
As on June 30, 2002		
Particulars	Amount Dr. (Rs.)	Amount Cr. (Rs.)
Raw Material stock Jul. 01, 2001	35,500	
Work in process Jul. 01, 2001	42,000	
Finished goods stock Jul. 01, 2001	85,000	
Raw material purchased	250,000	
Wages	180,000	
Freight inward	12,000	
Plant and machinery	400,000	
Office equipment	45,000	
Vehicles	200,000	
Acc. depreciation Plant		195,200
Acc. depreciation Office equipment		12,195
Acc. depreciation Vehicles		97,600
Factory overheads	125,000	
Electricity	80,000	
Salaries	140,000	
Salesman commission	120,000	
Rent	200,000	
Insurance	150,000	
General Expense	60,000	
Bank Charges	8,500	
Discounts Allowed	20,000	
Carriage outward	35,000	
Sales		1,500,000
Trade Debtors	250,000	
Trade Creditors		220,000
Bank	165,000	
Cash	110,000	
Drawings	175,000	
Capital July 01, 2001		863,005
Total	2,888,000	2,888,000

Notes:

- Stock on June 30, 2002.
 - Raw Material 42,000
 - Work in Process 56,500
 - Finished Goods 60,000

- 50% of electricity, insurance and salaries are charged to factory and balance to office.
- Depreciation to be charged on Plant & Machinery at 20%, Office Equipment at 10% and Vehicles at 20% on WDV.
- Write off bad debts Rs. 30,000.
- All the wages are direct expense.

Required:

You are required to prepare profit and loss account for the year and balance sheet as on June 30, 2002.

Solution**Profit & Loss Account**

Hassan Manufacturer Concern		
Profit and Loss Account		
For the Year Ending June 30, 2002		
Particulars	Note	Amount Rs.
Sales		1,500,000
Less: Cost of Goods Sold	1	796,960
Gross Profit		703,040
Less: Administrative Expenses	2	518,761
Less: Selling Expenses	3	155,000
Operating Profit		29,279
Less: Bank Charges		8,500
Net Profit Before Tax		20,779

Balance Sheet

Hassan Manufacturer Concern		
Profit and Loss Account		
For the Year Ending June 30, 2002		
Particulars	Note	Amount Rs.
Fixed Assets at WDV	4	275,284
Current Assets	5	653,500
Current Liabilities	6	(220,000)
Working Capital		433,500
Total Assets Employed		708,784
Financed by:		
Capital		863,005
Add: Profit for the year		20,779
Less: Drawings		(175,000)
Total Liabilities		708,784

Notes to the Accounts**Note # 1 Cost of Goods Sold**

Stock of Raw Material Jul 01, 2001	35,500
Add. Purchases	250,000
Add. Freight Inward	12,000
	297,500
Less: Closing Stock of Raw Material	(42,000)
Raw Material Consumed	255,500
Direct labor	180,000
Factory Overheads	
Factory Overheads	125,000
Electricity (50% of 80,000)	40,000

Salaries (50% of 140,000)	70,000	
Insurance (50% of 150,000)	75,000	
Plant Depreciation (Note 5)	<u>40,960</u>	350,960
Total Factory Cost		786,460
Add: Work in Process Jul 01, 2001		42,000
Less: Work in Process Jun 30, 2002		<u>(56,500)</u>
Cost of Goods Manufactured		771,960
Add: Finished Goods Stock Jul 01, 2001		85,000
Less: Finished Goods Stock Jun 30, 2002		<u>(60,000)</u>
Cost of Goods Sold		<u>796,960</u>

Note # 2 Administrative Expenses

Salaries (50% of 140,000)	70,000
General Expenses	60,000
Rent	200,000
Insurance (50% of 150,000)	75,000
Discount Allowed	20,000
Bad Debts	30,000
Office Electricity (50% of 80,000)	40,000
Depreciation Vehicles (Note 5)	20,480
Depreciation Office Equip. (Note5)	<u>3,281</u>
Administrative Expenses	<u>518,761</u>

Note # 3 Selling Expenses

Salesman Commission	120,000
Carriage Outward	<u>35,000</u>
Selling Expenses	<u>155,000</u>

Note # 4 Fixed Assets at WDV

	Cost	Rate	Acc. Depreciation			WDV
			Opening	For the year	Closing	
Plant & Mach.	400,000	20%	195,200	40,960	236,160	163,840
Vehicles	200,000	20%	97,600	20,480	118,080	81,920
Office Equipment	45,000	10%	12,195	<u>3,281</u>	15,476	<u>29,524</u>
				<u>64,721</u>		<u>275,284</u>

Note # 5 Current Assets

Stock	
Raw Material	42,000
Work in Process	56,500
Finished Goods	<u>60,000</u>
Debtors	250,000
Less: Bad Debts	<u>(30,000)</u>
Bank	165,000
Cash	<u>110,000</u>
Current Assets	<u>653,500</u>

Note # 6 Current Liabilities

Trade Creditors	220,000
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Illustration # 2

Following trial balance has been extracted from the books of Javed Furniture Manufacturers on June 30, 2002.

Javed Furniture Manufacturers		
Trial balance		
As on June 30, 2002		
Particulars	Amount Dr. (Rs.)	Amount Cr. (Rs.)
Raw Material stock Jul. 01, 2001	52,500	
Work in process Jul. 01, 2001	97,250	
Finished goods stock Jul. 01, 2001	33,750	
Raw material purchased	925,000	
Wages	812,500	
Freight inward	8,750	
Plant and machinery	700,000	
Office equipment	50,000	
Acc. depreciation Plant		125,000
Acc. depreciation Office equipment		20,000
General factory overheads	77,500	
Office electricity	18,750	
Factory power	34,250	
Salaries administrative staff	110,000	
Salaries sales staff	75,000	
Salesman commission	28,750	
Rent	30,000	
Insurance	10,500	
General Admin. Expense	33,500	
Bank Charges	5,750	
Discounts Allowed	12,000	
Carriage outward	14,750	
Sales		2,500,000
Trade Debtors	355,750	
Trade Creditors		312,500
Bank	142,000	
Cash	21,250	
Drawings	50,000	
Capital July 01, 2001		742,000
Total	3,699,500	3,699,500

Notes:

- Stocks on June 30, 2002
 - Raw Material Rs. 60,000
 - Finished Goods Rs. 100,000
 - Work in Process Rs. 37,500.
- Out of total wages Rs. 450,000 is direct and balance indirect.
- 80% of Rent and Insurance are to be apportioned to factory and balance to administrative office.
- Depreciation to be charged on Machinery at 20% and Office Equipment at 10% on cost.

You are required to prepare profit and loss account for the year and balance sheet as on June 30, 2002.

Solution

Javed Furniture Manufacturer		
Profit and Loss Account		
For the Year Ending June 30, 2002		
Particulars	Note	Amount Rs.
Sales		2,500,000
Less: Cost of Goods Sold	1	2,016,400
Gross Profit		483,600
Less: Administrative Expenses	2	175,350
Less: Selling Expenses	3	118,500
Operating Profit		189,750
Less: Financial Charges	4	17,750
Net Profit Before Tax		172,000

Javed Furniture Manufacturers		
Balance sheet		
For the Year Ending June 30, 2002		
Particulars	Note	Amount Rs.
Fixed Assets at WDV	5	460,000
Current Assets	6	716,500
Current Liabilities	7	(312,500)
Working Capital		404,000
Total Assets Employed		864,000
Financed by:		
Capital		742,000
Add: Profit for the year		172,000
Less: Drawings		(50,000)
Total Liabilities		864,000

Working 1 – Cost of Goods Sold

Stock of Raw Material Jul 01, 2001	52,500
Add. Purchases	925,000
Add. Carriage Inward	<u>8,750</u>
	986,250
Less: Closing Stock of Raw Material	<u>(60,000)</u>
Raw Material Consumed	926,250
Direct labor	450,000
Factory Overheads	
General Factory Overheads	77,500
Power	34,250
Rent (80% of 30,000)	24,000
Insurance (80% of 10,500)	8,400
Plant dep. On cost (Note 5)	140,000
Indirect Labor	<u>362,500</u>
	<u>646,650</u>
Total Factory Cost	2,022,900
Add: Work in Process Jul 01, 2001	97,250
Less: Work in Process Jun 30, 2002	<u>(37,500)</u>
Cost of Goods Manufactured	2,082,650
Add: Finished Goods Stock Jul 01, 2001	33,750
Less: Finished Goods Stock Jun 30, 2002	<u>(100,000)</u>
Cost of Goods Sold	<u>2,016,400</u>

Working 2 – Administrative Expenses

Administrative Salaries	110,000
Rent (20% of 30,000)	6,000
Insurance (20% of 10,500)	2,100
General Admin Expenses	33,500
Office Electricity	18,750
Depreciation Office Equip. (Note5)	<u>5,000</u>
Administrative Expenses	<u>175,350</u>

Working 3 – Selling Expenses

Salesman's Salary	75,000
Commission on Sales	28,750
Carriage Outward	<u>14,750</u>
Selling Expenses	<u>118,500</u>

Working 4 – Financial Expenses

Bank Charges	5,750
Discount Allowed	<u>12,000</u>
Financial Expenses	<u>17,750</u>

Working 5 – Fixed Assets at WDV

	Cost	Rate	<u>Acc. Depreciation</u>			WDV
			Opening	For the year	closing	
Plant and Mach.	700,000	20%	125,000	140,000	265,000	435,000
Office equipment.	50,000	10%	20,000	<u>5,000</u>	25,000	<u>25,000</u>
				<u>145,000</u>		<u>460,000</u>

Working 6 – Current Assets

Stock	
Raw Material	60,000
Work in Process	37,500
Finished Goods	<u>100,000</u>
Debtors	355,750
Bank	142,000
Cash	<u>21,250</u>
Current Assets	<u>716,500</u>

Working 7 – Current Liabilities

Creditors	<u>312,500</u>
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Lesson-34**FINANCIAL STATEMENTS OF PARTNERSHIP****Example # 1**

The following trial balance was extracted from A, B & Co. books on June 30, 2002.

A B & company		
Trial balance		
As on June 30, 2002		
Particulars	Amount Dr. (Rs.)	Amount Cr. (Rs.)
Building Cost	750,000	
Furniture and Fixtures Cost	110,000	
Accumulated Dep. Building		250,000
Accumulated Dep. Furniture		33,000
Debtors	162,430	
Creditors		111,500
Cash at Bank	6,770	
Stock on Jun 30, 2002	563,400	
Sales		1,236,500
Cost of goods Sold	710,550	
Carriage outward	12,880	
Discounts Allowed	1,150	
Markup on Bank Loan	40,000	
Office Expenses	24,160	
Salaries and Wages	189,170	
Bad Debts	5,030	
Provision for Bad Debts		4,000
Bank Loan (Long Term)		400,000
Capital – A		350,000
B		295,000
Current Account – A		13,060
B		2,980
Drawings – A	64,000	
B	56,500	
Total	2,696,040	2,696,040

Notes:

- Expenses to be accrued, Office Expenses Rs. 960, Wages Rs.2,000.
- Depreciate Fixtures 10% and Building 5% on straight line.
- Reduce provision for doubtful debts to Rs. 3,200
- Partnership salary of A Rs. 8,000 is to be accrued.
- A and B share profit and loss equally.

You are required to prepare profit & loss account and the balance sheet as at June 30, 2002.

Solution**Profit & Loss Account**

A, B, & Co			
Profit and Loss Account			
For the Year Ending June 30, 20-_____			
Particulars	Note	Amount Rs.	Amount Rs
Sales			1,236,500
Less: Cost of Goods Sold (material consumed)			(710,550)
Gross Profit			525,950
Less: Expenses			
Wages and Salaries	1	191,170	
Office Expenses	2	25,120	
Carriage Out		12,880	
Discount Allowed		1,150	
Markup on Loan		40,000	
Provision for Doubtful Debt	3	4,230	
Depreciation	4	48,500	
			(323,050)
Net Profit			202,900

In above solution, bad debts are grouped with provision for doubtful debts. In the following solution, bad debts and provision for doubtful debts are shown separately.

A, B, & Co			
Profit and Loss Account			
For the Year Ending June 30, 20-_____			
Particulars	Note	Amount Rs.	Amount Rs.
Sales			1,236,500
Less: Cost of Goods Sold (material consumed)			(710,550)
Gross Profit			525,950
Less: Expenses			
Wages and Salaries	1	191,170	
Office Expenses	2	25,120	
Carriage Out		12,880	
Discount Allowed		1,150	
Markup on Loan		40,000	
Bad Debts		5,030	
Provision for Doubtful Debts not required	3(a)	(800)	
Depreciation	4	48,500	
			(323,050)
Net Profit			202,900

Profit & Loss Appropriation Account

A, B, & Co			
Profit Distribution Account			
Particulars	Note	Amount Rs.	Amount Rs.
Net Profit			202,900
Less: Partner's Salary – A			(8,000)
Distributable Profit			194,900
Less: Partner's Share in Profit			
A (50% of 194,900)		97,450	
B (50% of 194,900)		97,450	(194,900)
			0

Balance Sheet

A, B, & Co			
Balance Sheet			
As At June 30, 2002			
Particulars	Note	Amount Rs.	Amount Rs.
Fixed Assets at WDV	4		528,500
Current Assets	5		729,400
Current Liabilities	6		(114,460)
Working Capital			614,940
Total			1,143,440
Financed By:			
Capital – A		350,000	
B		295,000	645,000
Current Account – A	7	54,510	
B	8	43,930	98,440
Long Term Loan			400,000
Total			1,143,440

Notes to the Accounts:**Note # 1 Salaries account**

Salaries Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Salaries paid	189,170		
Salaries payable	2,000		
		Balance b/d	191,170
Total	191,170	Total	191,170

Note # 2 Office Expenses

Office Expenses Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Office Expenses paid	24,160		
Office Expenses payable	960		
		Balance b/d	25,120
Total	25,120	Total	25,120

Note # 3 Provisions for Doubtful Debts

Provision for Doubtful Debts Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Bad Debts	5,030	Opening Balance	4,000
Balance c/d	3,200	Transfer to Profit & Loss Account	4,230
Total	8,230	Total	8,230

Note # 3(a) Provision for Doubtful Debts

Provision for Doubtful Debts Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Provision not required	800	Opening Balance	4,000
Balance c/d	3,200		
Total	4,000	Total	4,000

Note # 4 Fixes Assets at WDV

	Cost	Rate	Acc. Dep.			WDV
			Opening	For the Yr.	Closing	
Building	750,000	5%	250,000	37,500	287,500	462,500
Furniture	110,000	10%	33,000	<u>11,000</u>	44,000	<u>66,000</u>
				48,500		528,500

Note # 5 Current Assets

Stocks		563,400
Debtors	162,430	
Less: Provision (note3)	<u>3,200</u>	159,230
Bank		<u>6,770</u>
Total		729,400

Note # 6 Current Liabilities

Creditors		111,500
Exp. Payable:		
Salaries		2,000
Off. Exp		<u>2,960</u>
Total		114,460

Note # 7 A's Current Account

A's Current Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Drawings	64,000	Opening Balance	13,060
		Profit for the year	97,450
Balance c/d	54,510	Salary	8,000
Total	118,510	Total	118,510

Note # 8 B's Current Account

B's Current Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Drawings	56,500	Opening Balance	2,980
		Profit for the year	97,450
Balance c/d	43,930		
Total	100,430	Total	100,430

Example # 2

Atif, Amir and Babar are partners in a firm. They share profit and losses in the ratio 5: 3: 2 respectively. Their trial balance as on June 30, 2002 is as follows:

Atif, Amir, Babar & company		
Trial balance		
As on June 30, 2002		
Particulars	Amount Dr. (Rs.)	Amount Cr. (Rs.)
Sales		210,500
Returns inward	6,800	
Purchases	137,190	
Carriage inward	1,500	
Opening stock	42,850	
Discount allowed	110	
Salaries and Wages	18,296	
Bad debts	1,234	
Provision for bad debts		800
General expenses	945	
Rent and rates	2,565	
Postages	2,450	
Motor expenses	3,940	
Motor van at cost	12,500	
Office equipment at cost	8,400	
Accumulated depreciation Motor van		4,200
Accumulated depreciation Office equipment		2,700
Creditors		24,356
Debtors	37,178	
Cash at bank	666	
Drawings: Atif	12,610	
Amir	8,417	
Babar	6,216	
Current accounts: Atif		1,390
Amir	153	
Babar		2,074
Capital accounts: Atif		30,000
Amir		16,000
Babar		12,000
Total	304,020	304,020

The following notes are relevant to June 30, 2002

- Stock on June 30,2002 is Rs. 51,060.
- Rent in advance Rs. 120.
- Increase provision for bad debts to Rs. 870.
- Salaries: Amir Rs.1,200, Babar Rs. 700.
- Interest on capital @ 10%.
- Depreciate Motor van Rs. 2,500 and office equipment Rs. 1,680.

You are required to draw up a set of final accounts as on June 30, 2002.

Solution**Profit & Loss Account**

Atif, Amir, Babar & company			
Profit and Loss Account			
For the Year Ending June 30, 20-2			
Particulars	Note	Amount Rs.	Amount Rs
Sales	1		203,700
Less: Cost of Goods Sold	2		(130,480)
Gross Profit			73,220
Less: Expenses			
Wages and Salaries		18,296	
General Expenses		945	
Rent and Rates	3	2,445	
Postages		2,450	
Motor Expenses		3,940	
Discount Allowed		110	
Provision for Doubtful Debt	4	1,304	
Depreciation	5	4,180	(33,670)
Net Profit			39,550

Profit & Loss Appropriate Account

Atif, Amir, Babar & company			
Profit Distribution Account			
Particulars	Note	Amount Rs.	Amount Rs.
Net Profit			39,550
Less: Partner's Salary – Amir			(1,200)
Babar			(700)
Less: Interest on capital – Atif (10% of 30,000)			(3,000)
Amir (10% of 16,000)			(1,600)
Babar (10% of 12,000)			(1,200)
Distributable Profit			31,850
Less: Partner's Share in Profit			
Atif (5/10 of 31,850)		15,925	
Amir (3/10 of 31,850)		9,555	
Babar (2/10 of 31,850)		6,370	(31,850)
			0

Balance Sheet

Atif, Amir, Babar & company			
Balance Sheet			
As At June 30, 2002			
Particulars	Note	Amount Rs.	Amount Rs.
Fixed Assets at WDV	5		9,820
Current Assets	6		88,154
Current Liabilities	7		(24,356)
Working Capital			63,798
Total			73,618
Financed By:			
Capital – Atif		30,000	
Amir		16,000	
Babar		12,000	58,000
Current Account – Atif	8	7,705	
Amir	9	3,785	
Babar	10	4,128	15,618
Total			73,618

Notes to the Accounts**Note # 1 Sales**

	Rs.
Sales	210,500
Less: Return inward	(6,800)
Net Sales	203,700

Note # 2 Cost of goods sold

Opening Stock	42,850
Add: Purchases	137,190
Add: Carriage inward	1,500
Less: Closing Stock	(51,060)
	130,480

Note # 3 Rent and Rates

Rent and Rates Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Office Expenses paid	2,565	Advance Rent	120
		Balance b/d	2,445
Total	2,565	Total	2,565

Note # 4 Provisions for Doubtful Debts

Provision for Doubtful Debts Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Bad Debts	1,234	Opening Balance	800
Balance c/d	870	Transfer to Profit & Loss Account	1,304
Total	2,104	Total	2,104

Note # 5 Fixed Assets at WDV

	Cost	Acc dep.			WDV
		Opening	For the Yr.	Closing	
Motor Van	12,500	4,200	2,500	6,700	5,800
Office Equipment	8,400	2,700	1,680	4,380	4,020
		4,180			9,820

Note # 6 Current Assets

Stock	51,060
Debtors	37,178
Less: Provision for doubtful debts	(870)
Cash at bank	666
Advance rent	120
	88,154

Note # 7 Current Liabilities

Creditors	24,356
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Note # 8 Atif's Current Account

Atif's Current Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Drawings	12,610	Opening Balance	1,390
		Interest on Capital	3,000
		Profit for the year	15,925
Balance c/d	7,705		
Total	20,315	Total	20,315

Note # 9 Amir's Current Account

Amir's Current Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Opening Balance	153	Salary	1,200
Drawings	8,417	Interest on Capital	1,600
		Profit for the year	9,555
Balance c/d	3,785		
Total	12,355	Total	12,355

NOTE # 10 Babar's Current Account

Babar's Current Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Drawings	6,216	Opening Balance	2,074
		Salary	700
		Interest on Capital	1,200
		Profit for the year	6,370
Balance c/d	4,128		
Total	10,344	Total	10,344

Lesson-35**MARK UP ON CAPITAL AND DRAWINGS**

The partnership agreement may include one or both of the following clauses:

- Partners are charged interest on drawings (this may be on the total amount of the current account balance or on the amount exceeding a specific limit, depending upon the terms of agreement).
- Partners are given interest on their capital (again this can be on the total amount of the capital or the amount exceeding a specific figure).

Reasons for Interest On Capital

The profit/loss sharing ratio may not be equal despite of the fact that partners have contributed equal amount of capital, depending upon the partnership agreement. Take the following example:

Two partners start a business and contribute equal capital and decide to share equal profits. But they also realize that in future the business may need further capital and at that time both partners may not be able to contribute equally. So, instead of revising the contract every time, they include a clause in the agreement, whereby, the partners are allowed an interest on the capital contributed. This interest can be on the whole amount of both partners or only of one partner on the amount contributed in excess of the other partner. This way a partner, who provides capital in excess of his profit sharing ratio, can be compensated. One may say that the same results can be achieved by saying that profit and loss sharing will be proportionate to the amount of capital invested. But, as we have said that in partnership everything depends on the Partnership Agreement.

Reasons for Interest On Drawings

Drawings are opposite to capital invested i.e. these are the funds drawn by partners from the business. Therefore, in order to keep the distribution of profit fair, a clause may be inserted in the agreement, where an interest is charged on the drawings of the partners. Again, this can be on the total amount or on an amount exceeding a specific limit. Both of the above things depend upon the agreement between partners.

Accounting Treatment

One may think that as Interest on Capital is paid to the partners, so it should be treated as business expense and Interest on Drawings is charged from the partners, therefore, it should be treated as income. But this is not the case.

Just like partners salaries, both these items will be included in the Profit and Loss Appropriation Account. Partners' salaries, interests etc. are never treated as expense or income of the business. They are a part of DISTRIBUTION OF PROFIT.

Exceptions

Rent paid to partner for use of his premises, purchase of stocks, assets or other items for use in business, Markup on loan from partner are the exceptions. All these expenses are charged to profit & loss account of the partnership firm.

Accounting Entries

- **Interest on Capital**

Debit:	Profit and Loss Appropriation Account
Credit:	Partner A's Current Account
Credit:	Partner B's Current Account
Credit:	Partner C's Current Account

○ **Interest on Drawings**

Debit:	Partner A's Current Account
Debit:	Partner B's Current Account
Debit:	Partner C's Current Account
Credit:	Profit and Loss Appropriation Account

Example # 1

Mr. Abid is a partner in a partnership firm. His capital on July 1, 2001 was Rs. 200,000. He invested further capital of Rs. 100,000 on March 1, 2002.

You are required to calculate his mark up. Mark up rate is 5%. The financial year is from July to June.

Solution

Rs. 200,000 was invested in the beginning of the year and extra capital was invested on 1st March. So, from March onward, the capital is Rs. 300,000 (200,000 + 100,000). We will calculate mark up on Rs. 200,000 for 12 months, i.e., from July to June. Mark up on 100,000 will be for 4 months, i.e., from March to June.

Mark up is calculated as follows:

$$\begin{array}{r}
 200,000 \times 5\% = 10,000 \quad = \quad 10,000.00 \\
 100,000 \times 5\% = 15,000 \times 4/12 = \quad \underline{1666.67} \\
 \text{Total Mark Up} \quad \quad \quad \underline{11,666.67}
 \end{array}$$

Example # 2

Mr. Naeem is a partner in a partnership firm. He drew following amount during the financial year:

	Rs.
September 1	3,000
November 1	5,000
January 1	4,000
March 1	5,000
June 1	2,000

You are required to calculate Mark up on his drawings, if the rate of mark up is 5%. The financial year is from July to June,

Solution

$$\begin{array}{r}
 3,000 \times 5\% = 150 \times 10/12 = 125.00 \\
 5,000 \times 5\% = 250 \times 8/12 = 166.67 \\
 4,000 \times 5\% = 200 \times 6/12 = 100.00 \\
 5,000 \times 5\% = 250 \times 4/12 = 83.33 \\
 2,000 \times 5\% = 100 \times 1/12 = \underline{8.33} \\
 \text{Total Mark Up} \quad \quad \quad \underline{483.33}
 \end{array}$$

Example # 3

Atif, Babar and Dawar are three partners sharing profits equally.

You are required to prepare profit and loss appropriation account and extract from balance sheet, showing partners capital and current accounts from the following information:

- Net profit for the year Rs. 558,000
- Opening balance of Capital accounts Atif Rs. 500,000, Babar Rs. 600,000, Dawar Rs. 400,000
- Opening balance of Current Account Atif Rs. 55,800, Babar Rs. 63,820, Dawar Rs. 20,555.
- Salaries to be paid to Babar Rs. 10,000, Dawar Rs. 12,000.
- Drawings during the year Atif Rs. 180,000, Babar Rs. 220,000 Dawar Rs. 151,000
- Mark up on Capital @ 5% and Mark up on drawings are: Atif Rs. 9,000, Babar Rs. 11,000 and Dawar Rs. 7,550.

Solution**Profit & Loss Appropriation Account**

Atif, Babar, Dawar & Co			
Profit Distribution Account			
Particulars	Note	Amount Rs.	Amount Rs.
Net Profit			558,000
Less: Partner's Salary – Babar		10,000	
Dawar		12,000	(22,000)
Less: Interest on capital – Atif (5% of 500,000)		25,000	
Babar (5% of 600,000)		30,000	
Dawar(5% of 400,000)			(75,000)
		20,000	
Add: Interest on Drawings – Atif			
Babar		9,000	
Dawar		11,000	
		7,550	27,550
Distributable Profit			488,550
Less: Partner's Share in Profit			
Atif (1/3 of 488,550)		162,850	
Amir (1/3 of 488,550)		162,850	
Babar (1/3 of 488,550)		162,850	(488,550)
			0

Atif's Current Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Drawings	180,000	Opening Balance	55,800
Interest on Drawings	9,000	Interest on Capital	25,000
		Profit for the year	162,850
Balance c/d	54,650		
Total	243,650	Total	243,650

Babar's Current Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Drawings	220,000	Opening Balance	63,820
Interest on Drawings	11,000	Salary	10,000
		Interest on Capital	30,000
		Profit for the year	162,850
Balance c/d	35,670		
Total	266,670	Total	266,670

Dawar's Current Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Drawings	151,000	Opening Balance	20,555
Interest on Drawings	7,550	Salary	12,000
		Interest on Capital	20,000
		Profit for the year	162,850
Balance c/d	56,855		
Total	215,405	Total	215,405

Admission of A Partner

When a new partner join the business, old agreement of partnership is modified or a new agreement is prepared. This new agreement contains new ratios in which partners share profit and loss in new set up. At the admission of a new partner, all the assets and liabilities of the old business are revalued in order to know the exact worth of the business. Goodwill of the business is also revalued. The value (in monetary terms) of the reputation of the business is called GOODWILL. It is an intangible asset.

Dissolution of A Firm

When a partnership is dissolved, all the liabilities of the firm are paid, out of the assets of the firm, available at the time of dissolution. The remaining amount after paying all the liabilities, if available, will be distributed among the partners in their profit loss sharing ratios. If assets of the firm are not sufficient to pay all the liabilities of the firm, the partners will contribute the balance amount in their profit/loss sharing ratios to meet the liabilities of the firm.

Lesson-36**INTRODUCTION TO COMPANIES****Disadvantages of Partnership Firm**

The Local Law restricts the number of partners in a partnership firm to twenty. If the firm needs more capital for its business, the partners may not be in a position to invest more money in the business.

Secondly, if the business of the partnership firm is very large and twenty persons can not manage it, they cannot admit new partners in the business. However, there is one exception. The partnership firm of professionals can have more than twenty partners.

At this point, need for forming a COMPANY arises.

Advantages of Limited Company

A Limited company enjoys the following benefits:

- It can have more than twenty partners, so problem of extra capital is reduced to minimum.
- The liabilities of the members of a company is limited to the extent of capital invested by them in the company
- There are certain tax benefits to the company, which a partnership firm can not enjoy.
- In Pakistan, affairs of limited companies are controlled by COMPANIES ORDINANCE issued in 1984.
- The formation of a company and other matters related to companies are governed by SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN (SECP).

Types of Companies

There are two major types of the companies:

- Private limited companies
- Public limited companies

Private Limited Companies

Following are the main characteristics of private limited companies:

- Number of members in a private limited company ranges from two to fifty.
- Words and parentheses “(Private) Limited” are added at the end of the name of a private limited company. Example: ABC (Private) Limited.
- Private limited company can not offer its shares to general public at large.
- In case a shareholder decides to sell his shares, his shares are first offered to existing shareholders. If all existing shareholders decide not to purchase these shares, only then, an outsider can buy them.
- The shareholders of the private limited company elect two members of the company as Directors.
- These directors form a board of directors to run the affairs of the company.
- The head of board of directors is called “chief executive”.

Public Limited Company

Following are the main characteristics of public limited companies:

- Minimum number of members in a public limited company is **seven**
- There is no restriction on the maximum number of members in a public limited company.
- Word “Limited” is added at the end of the name of a public limited company. Example: ABC Limited.

- Public limited company can offer its shares to general public at large.
- The shareholders of the public limited company elect seven members of the company as Directors.
- These directors form a board of directors to run the affairs of the company.
- The head of board of directors is called “chief executive”.

There are two types of public limited company:

- Listed Company
- Non Listed Company

Listed Company

Listed company is that company whose shares are quoted on stock exchange. i.e. whose shares are traded in stock exchange. It is also called quoted company.

Non Listed Company

Non listed company is that company whose shares are not quoted on stock exchange. i.e. whose shares are not traded in stock exchange.

Formation of Company

In case of private limited company, any two members and in case of public limited company, any seven members can subscribe their names in Memorandum and Articles of association along with other requirements of the Companies Ordinance 1984; can apply to Security and Exchange Commission for registration of the company.

Memorandum of association:

Memorandum of association contains the following clauses:

- Name of the company with the word “Limited” as the last word of the name, in case of public limited and the parenthesis and the word “(Private Limited)” as the last word of the name, in case of private limited company.
- Place of registered office of the company.
- Objective of the company.
- Amount of share capital with which company proposes to be registered and division in to number of shares.
- No subscriber of the company shall take less than one share.
- Each subscriber of the memorandum shall write opposite to his name, the number of shares held by him.

Articles of Association

- Article of association is a document that contains all the policies and other matters which are necessary to run the business of the company.
- This is also signed by all the members of the company.

When Security and Exchange Commission is satisfied that all the requirements of the Companies Ordinance have been complied with, it issued certificate of incorporation to the company. This certificate is evidence that a separate legal entity has come in to existence.

Authorized Share Capital

The maximum amount with which a company gets registration/incorporation is called authorized share capital of that company.

This capital can be increased with the prior approval of security and exchange commission. This capital is further divided in to smaller denominations called shares. Each share usually has a face value equal to Rs. 10. According to Companies Ordinance, this face value can be increased but can not be decreased. The value of share written on its face is called face value or par value or nominal value

Issued Share Capital

When a company issues its shares to general public at large, the amount raised by the company with such an issue is called issued share capital. This is also called Paid up Share Capital.(total amount received by the company). Accounting entry is recorded for issued share capital; no such entry is recorded for authorized share capital.

Preliminary Expenses

All expenses incurred up to the stage of incorporation of the company are called Preliminary Expenses. All these expenses are incurred by subscribers of the company.

Lesson-37**COMPONENTS OF FINANCIAL STATEMENTS**

The maximum amount with which a company gets registration/incorporation is called authorized share capital of that company. This capital can be increased with the prior approval of security and exchange commission. This capital is further divided in to smaller denominations called **shares**. Each share usually has a face value equal to Rs. 10. According to Companies Ordinance, this face value can be increased but can not be decreased. The value of share written on its face is called **face value**.

Shares are issued for cash as well as for any asset. For example, if any member of the company sell his/her land to the company. In return, company issue him/her fully paid shares instead of paying cash. Those shares are also part of paid up capital because company has received the benefit of that amount.

Share Certificate

Share Certificate is the evidence of ownership of the number of shares held by a member of the company. When a company issue more than one share to its member, it does not issue that number of shares to him/her. Instead, it issues a certificate under the stamp of the company that a particular number of shares are issued to members of the company.

Shares Issued At Premium

When a company has a good reputation and earns huge profits, the demand of its shares increases in the market. In that case, the company is allowed by the Companies Ordinance 1984, to issue shares at a higher price than their face value. Such an issue is called Shares **Issued at Premium**. The amount received in excess of the face value of the shares is transferred to an account called "**Share Premium Account**". This account is used to:

- Write off Preliminary Expenses of the company.
- Write off the balance amount, in issuing shares on discount.
- Issue fully paid Bonus Shares.

Shares Issued On Discount

When a company is not making huge profits, rather it is sustaining loss, the demand of its shares decreases in the market. If the company needs extra funds, then it is allowed by the Companies Ordinance 1984, to issue shares at lesser price than their face value. Such an issue is called Shares Issued on discount.

The difference of face value and the amount received is met by share premium account, if available. If there is no share premium account available, this difference is shown in the profit and loss account of that period, in which shares are issued as loss on issue of shares at discount.

Certificate of Incorporation/Registration

When Security and Exchange Commission of Pakistan receives application for registration of a company, the registrar of SECP makes investigation in respect of compliance with legal requirements. When he is satisfied that all legal requirements are complied with. He issues a Certificate of Incorporation/registration to the company. This certificate is evidence that a separate legal entity has formed. The company, after incorporation/Registration has the right to sue and to be sued in its own name.

Dividend

Profit distributed to the share holders for their investment in the company is called **Dividend**. Dividend is approved by the share holders in the annual general meeting at the recommendation of the directors. Dividend is paid out of profits. If, in any year, company could not make any profit. No dividend will be

paid to share holders. Dividend is paid to registered share holders of the company. Registered share holders are those members of the company, who are enlisted in the register of share holders of the company.

Subscribers / Sponsors of the Company

Subscribers / Sponsors are the persons who sign articles and memorandum of the company and contribute in the initial share capital of the company.

Issuance of Further Capital

Where a company wants to issue further capital (called raising the capital), shares are first offered to current shareholders. The issuance of further capital to Present Shareholders is called **Right Issue**. This issue is in proportion to current shares held by the shareholders. The shareholders can accept or reject the offer. If shareholders refuse to accept these shares then these are offered to other people.

Journal Entries

- Shares issued against cash

Debit:	Cash / Bank Account
Credit:	Share Capital Account

- Shares issued against transfer of asset:

Debit:	Asset Account
Credit:	Share Capital Account

This is called issuance of asset in kind.

Bonus Shares

This is another way of distributing dividend. When a company decides, not to give cash to the share holders as dividend, it issued shares called bonus shares, to the share holders for which it receives no cash. These are fully paid shares.

Financial Statements of Limited Companies

In Pakistan, Financial Statements of limited companies are prepared in accordance with:

- International accounting standards adopted in Pakistan.
- Companies Ordinance 1984.

In case of conflict the requirements of Companies Ordinance would prevail over Accounting Standards.

Components of Financial Statements

Components of companies' financial statements are as follows:

- Balance Sheet
- Profit and Loss Account
- Cash Flow Statement
- Statement of Changes in Equity
- Notes to the Accounts
- Comparative figures of Previous Period

Equity

Equity is the total of capital, reserves and undistributed profit. That means the amount contributed by share holders plus accumulated profits of the company. Equity, therefore, represents the total of shareholders fund in the company.

Statement of Changes in Equity

The statement of changes in equity shows the movement in the shareholders equity (capital and reserves) during the year. We can say that it replaces profit and loss appropriation account of partnership business.

Format of Statement of Changes in Equity

Name of the Company					
Statement of Changes in Equity					
For Year Ended June 30, 2002					
	Share Capital	Share Premiu m Account	Reserves	Profit & Loss A/c	Total
Balance On Jun 30, 2000	X	X	X	X	X
Movements During the Year				X	X
Balance On Jun 30, 2001	X	X	X	X	X
Movements During the Year				X	X
Balance On June 30, 2002	X	X	X	X	X

Lesson-38**FINANCIAL STATEMENTS OF LIMITED COMPANIES****Statement of Changes in Equity**

Statement of changes in equity shows the movement in:

- Share Capital (issued share capital)
- Share Premium
- Nature of Reserves created
- Un-appropriated Profit / Loss
- Dividend Distributed

Share Premium

Share Premium is the amount received in excess of the face value of the share. Example: if a Rs. 10 share is sold for Rs. 12 then Rs. 2 is share premium. Share Premium can not be distributed among the share holders.

It can be utilized:

- To issue Bonus Shares
- To write off Preliminary Expenses
- To meet the difference of face value and cash received in case of shares issued at discount
- To meet the expenses of issue of shares
- For payment of premium on redemption of debentures.

Reserves

Capital Reserve and Fixed Asset Replacement Reserve are used for specific purpose. These are not distributed among share holders. General Reserve and undistributed profit` can be distributed among share holders. Revaluation Reserve is created when an asset is re-valued from cost to market value. Revaluation Reserve can not be distributed among the share holders. It can be utilized for:

- Setting off any loss on revaluation
- At the time of disposal of asset, the reserve relating to that asset is transferred to profit & loss account.

Cash Flow Statement

Cash Flow Statement shows the movement of cash resources during the year. It gives information about sources of income and account heads on which this amount is spent. It is an integral part of financial statements.

Notes to the Accounts

Notes to the accounts are the explanatory notes of all the items shown in the profit and loss account and the balance sheet. It is the requirement of the Companies Ordinance and the International Accounting Standards. Following are explained in Notes to the accounts:

- Nature of business of the company
- Accounting Policies of the company
- Details and explanation of items given in the Profit and Loss Account and Balance Sheet.

Debentures

Debentures are acknowledgement of debt, owed by the company to the public at large for a defined period of time, and has a mark up (profit) rate attached to it. Debentures are issued under the common

seal (Stamp) of the company. Debenture is an instrument for obtaining loan from general public. Mark up is paid on Debentures which is generally equal to the market rate.

Term Finance Certificate

Term Finance Certificates are issued for a defined period. These are also issued to obtain loan from public at large. Both Debentures and Term Finance Certificates are usually issued by Public Companies.

Illustration

ABC Limited		
Trial balance		
As on June 30, 2002		
Particulars	Amount Dr. (Rs.)	Amount Cr. (Rs.)
Authorized Share Capital (Face value Rs. 10 each)		1,500,000
Paid up Capital		1,000,000
Share Premium		120,000
General Reserve		48,000
Accumulated profit brought forward		139,750
Opening Stock	336,720	
Sales		4,715,370
Purchases	2,475,910	
Return outward		121,220
Return inward	136,200	
Carriage inward	6,340	
Carriage outward	43,790	
Wages	410,240	
Salesmen Salaries	305,110	
Admin. Wages & salaries	277,190	
Plant And Machinery	610,000	
Motor vehicle hire	84,770	
Provision for Depreciation: Plant & Machinery		216,290
General Selling Expenses	27,130	
General admin. expenses	47,990	
Directors' Remuneration	195,140	
Rent received		37,150
Trade Debtors	1,623,570	
Cash and Bank balances	179,250	
Trade Creditors		304,570
Bills Payable		57,000
Total	6,759,350	6,759,350

Additional Information

- Closing stock is valued at Rs. 412,780.
- Accrue Auditors' remuneration Rs. 71,000.
- Dividend is proposed @37.5% for the year.
- Depreciate plant & machinery @20% on cost.
- Of the motor hire, Rs. 55,000 is for selling purposes.
- Directors' remuneration has been as follows:

○ Chairman	46,640
○ Managing Director	51,500
○ Finance Director	46,000
○ Marketing Director	51,000
	195,140

You are required to prepare profit & loss account as on June 30, 2002 and balance sheet for the reported period.

Solution

While presenting the financial Statements of the company, balance sheet is presented first and profit & loss account is presented later, but we cannot prepare balance sheet without preparing profit and loss account. So we will prepare profit and loss account first.

Balance Sheet

ABC Limited		
Balance Sheet		
As At June 30, 2002		
Particulars	Note	
Fixed Assets at WDV	3-a	271,710
Current Assets		
Debtors		1,623,570
Stock in Trade		412,780
Cash & Bank Balance		179,250
		2,215,600
Current Liabilities		
Creditors		304,570
Bills Payable		57,000
Auditors Remuneration Payable		71,000
Proposed Dividend		375,000
		807,570
Working Capital		1,783,030
Net Assets Employed		1,679,740
Financed By:		
Authorized Capital 50,000 Shares of Rs. 10 each		1,500,000
Paid Up Capital 30,000 Shares of Rs. 10 each		1,000,000
Share Premium		120,000
General Reserve		48,000
Accumulated Profit and Loss Account		511,740
Total		1,679,740

Profit & Loss Account

ABC Limited			
Profit and Loss Account			
For the Year Ending June 30, 20-2			
Particulars	Note	Amount Rs.	Amount Rs
Sales	1		4,579,170
Less: Cost of Goods Sold	2		(2,695,210)
Gross Profit			1,883,960
Add: other income (rent received)			37,150
Less: Administrative Expenses	3	692,090	
Less: Selling Expenses	4	<u>482,030</u>	<u>(1,174,120)</u>
Profit before tax			746,990
Less: Tax for the year			<u>0</u>
Profit after tax			746,990
Add: Accumulated Profit b/f			<u>139,750</u>
			886,740
Less: Proposed Dividend @ 37.5%	5		375,000
Net Profit Carried Forward			511,740

Notes to the Accounts**Note # 1 Sale account**

Sales	4,715,370
Less: Return in	<u>(136,200)</u>
Net Sales	<u>4,579,170</u>

Note # 2 Cost of goods sold

Opening Stock	336,720
Add: Purchases	2,475,910
Wages	410,240
Less: Returns out	(121,220)
Add: Carriage in	6,340
Less: Closing Stock	<u>(412,780)</u>
Total	<u>2,695,210</u>

Note # 3 Administrative Expenses

Wages & salaries	277,190
Motor Hire	29,770
General Expenses	47,990
Directors Remuneration:	
Chairman	46,640
Managing Director	51,500
Director Finance	<u>46,000</u>
	144,140
Auditors Remuneration	71,000
Depreciation Plant & Machinery (Note # 3-a)	<u>122,000</u>
Total	<u>692,090</u>

Note # 3-Fixed Assets

	Cost	Rate	Acc. Dep.			WDV
			Opening	For the Yr.	Closing	
Plant & Machinery	610,000	20%	216,290	122,000	338,290	271,710

Note # 4 Selling Expenses

Salesmen salaries	305,110
Carriage out	43,790
General Expenses	27,130
Motor Hire	55,000
Marketing Director's Remuneration	<u>51,000</u>
Total	<u>482,030</u>

Note # 5 Proposed Dividends

37.5% of 1,000,000 (issued capital)	375,000
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Lesson-39**FINANCIAL STATEMENTS OF LIMITED COMPANIES (Continued)****Question # 1**

KKB (Private) Limited is a manufacturing company. Following list of balances has been extracted from its books as on June 30, 2002.

KKB (Private) Limited		
Trial Balance		
As At June 30, 2002		
Particulars	Rs.	Rs.
Authorized Share Capital		500,000
Paid up Capital		300,000
Debentures		240,000
Accumulated Profit and Loss Account		49,489
General Reserve		8,000
Creditors		27,360
Accumulated Depreciation		
Motor Vehicles		46,050
Building		66,000
Furniture and Fixtures		11,250
Proposed Dividend		15,000
Land	120,000	
Building	315,000	
Motor Vehicles	187,500	
Furniture and Fixture	34,500	
Stock in Trade	48,630	
Debtors	42,525	
Bank Balance	14,994	
TOTAL	763,149	763,149

Note:

All items of profit and loss have been accounted for in calculating the balance of accumulated profit and loss account, except for Depreciation which is to be charged at 10% on WDV on all depreciable assets.

Required

Prepare the balance sheet of Beta (Private) Limited As on June 30, 2002.

Solution**Balance Sheet**

KKB (Private) Limited		
Balance Sheet		
As At June 30, 2002		
Particulars	Note	Amount Rs.
Fixed Assets at WDV	1	492,330
Current Assets		
Debtors		42,525
Stock in Trade		48,630
Bank Balance		14,994
Current Liabilities		106,149
Creditors		27,360
Proposed Dividend		15,000
		42,360
Working Capital		63,789
Net Assets Employed		556,119
Financed By:		
Authorized Capital		
50,000 Shares of Rs. 10 each		500,000
Paid Up Capital		
30,000 Shares of Rs. 10 each		300,000
General Reserve		8,000
Accumulated Profit and Loss Account	2	8,119
Share Holders Equity		316,119
Debentures		240,000
Total		556,119

Note 1 – Fixed Assets at WDV

Particulars	Cost			Rate	Accumulated Depreciation			WDV
	As At 1-7-01	Addition/ Deletion	As At 30-6-02		As At 1-7-01	For The Year	As At 30-6-02	
Land	120,000	0	120,000	0	0	0	0	120,000
Building	315,000	0	315,000	10	66,000	24,900	90,900	224,100
Furniture & Fixtures	34,500	0	34,500	10	11,250	2,325	13,575	20,925
Vehicles	187,500	0	187,500	10	46,050	14,145	60,195	127,305
TOTAL	657,000	0	657,000		123,300	41,370	164,670	492,330

Note 2 – Accumulated Profit and Loss Account

Balance As Per Trial Balance	49,489
Less: Depreciation for the Year (note 1)	<u>(41,370)</u>
	8,119

As depreciation is charged in profit & loss account and we did not prepare profit & loss account, in this case, so depreciation will be deducted from accumulated profit & loss account.

Question # 2

ABC Limited		
Trial balance		
As on June 30, 2002		
Particulars	Amount (Rs.)	Amount (Rs.)
Authorized Share Capital (Face value Rs. 10 each)		1,500,000
Paid up Capital		1,200,000
Share Premium		75,000
General Reserve		150,000
Accumulated profit brought forward		215,000
Opening Stock	902,000	
Sales		4,575,000
Purchases	2,196,000	
Motor Expenses	164,000	
Bad debts	31,000	
Carriage inward	38,000	
Debenture Mark Up	40,000	
Mark up on bank overdraft	19,000	
Wages	832,000	
Directors' Remuneration	210,000	
General Expenses	154,000	
Long Term Investments	340,000	
Income from shares in related companies		36,000
Discount allowed & received	55,000	39,000
Profit on property sale		100,000
Building at cost	1,200,000	
Plant And Machinery at cost	330,000	
Motor Vehicles at cost	480,000	
Provision for Depreciation: Building		375,000
Plant & Machinery		195,000
Motor Vehicles		160,000
Goodwill	40,000	
Patents & Trade Marks	38,000	
Trade Debtors & Creditors	864,000	392,000
Bank Overdraft		21,000
Debenture 10%		400,000
Total	7,933,000	7,933,000

Notes:

- Closing stock is valued at Rs. 103,000.
- Depreciate building @ 10%, Plant & Machinery @ 20% and Vehicles @ 25%.
- Provision for tax to be created Rs. 236,000.

You are required to prepare Financial Statements of ABC Limited as on June 30, 2002.

Solution

ABC Limited		
Balance Sheet		
As At June 30, 2002		
Particulars	Note	
Fixed Assets at WDV	3-a	1,090,500
Long Term Investments		340,000
		1,430,500
Current Assets		
Debtors		864,000
Stock in Trade		103,000
Goodwill		40,000
Patents & Trade Marks		38,000
		1,045,000
Current Liabilities		
Creditors		392,000
Provision For Tax		236,000
Bank Overdraft		21,000
		649,000
Working Capital		396,000
Net Assets Employed		1,826,500
Financed By:		
Authorized Capital		
50,000 Shares of Rs. 10 each		1,500,000
Paid Up Capital		
30,000 Shares of Rs. 10 each		1,200,000
Share Premium		75,000
General Reserve		150,000
Accumulated Profit and Loss Account		1,500
Debentures		400,000
Total		1,826,500

Profit and Loss Account

ABC Limited			
Profit and Loss Account			
For the Year Ending June 30, 2002			
Particulars	Note	Amount Rs.	Amount Rs
Sales			4,575,000
Less: Cost of Goods Sold	1		(3,865,000)
Gross Profit			710,000
Add: other income	2		175,000
Less: Administrative Expenses	3	803,500	
Less: Financial Expenses	4	59,000	(862,500)
Profit before tax			22,500
Less: Provision for Tax			(236,000)
Profit after tax			(213,500)
Add: Accumulated Profit b/f			215,000
Net Profit Carried Forward			1,500

Notes**Note # 1 Cost of goods sold**

Opening Stock	902,000
Add: Purchases	2,196,000
Wages	832,000
Add: Carriage in	38,000
Less: Closing Stock	<u>(103,000)</u>
Total	<u>3,865,000</u>

Note # 2 Other Incomes

Income from shares in related companies	36,000
Discount received	39,000
Profit on property sale	<u>100,000</u>
Total	<u>175,000</u>

Note # 3 Administrative Expenses

Motor Expenses	164,000
Bad Debts	31,000
Directors' Remuneration	210,000
General Expenses	154,000
Depreciation (Note # 3-a)	189,500
Discount allowed	<u>55,000</u>
Total	<u>803,500</u>

Note # 4 Fixed Assets at WDV

	Cost	Rate	Acc. Depericiation			
			WDV			
			Opening	For the Yr.	Closing	
Building	1,200,000	10%	375,000	82,500	457,500	742,500
Plant & Machinery	330,000	20%	195,000	27,000	222 000	108,000
Motor Vehicles	480,000	25%	160,000	<u>80,000</u>	240,000	<u>240,000</u>
				<u>189,500</u>		<u>1,090,500</u>

Note # 5 Financial Expenses

Debenture Mark up	40,000
Mark up on Bank Overdraft	<u>19,000</u>
Total	<u>59,000</u>

Lesson-40**FINANCIAL STATEMENTS OF LIMITED COMPANIES (Continued)****Question**

Following trial balance has been extracted from the books of Alpha Ltd. as on June 30, 2002.

You are required to prepare the profit and loss account for the year and the Balance Sheet as at June 30, 2002.

Alpha Limited		
Trial Balance		
As at June 30, 2002		
Title of Account	Dr. Rs.	Cr. Rs.
Paid up capital		175,000
10 % Debentures		75,000
Building at Cost	237,500	
Equipment at Cost	20,000	
Vehicles at Cost	43,000	
Accumulated Dep. – Building		11,250
Equipment		6,000
Vehicles		12,900
Stock Opening Balance	56,725	
Sales		245,500
Purchases	134,775	
Carriage Inward	4,050	
Salaries and Wages	23,100	
Directors Remuneration	15,750	
Vehicle Running Expenses	20,300	
Insurance	7,325	
Miscellaneous Expenses	1,400	
Markup on Debentures	3,750	
Debtors	46,525	
Creditors		28,425
Bank	20,975	
General Reserve		12,500
Share Premium Account		35,000
Interim Dividend Paid	8,750	
Accumulated Profit and Loss account		42,350
TOTAL	643,925	643,925

Additional Information:

- Closing stock Rs. 68,050.
- Depreciation Building 5,000, Vehicles Rs 7,500, Equipment 3,000.
- Six months Debenture markup is to be accrued.
- 10% final dividend is to be paid in addition to interim dividend.
- Transfer Rs. 5,000 to general reserve.
- Authorized share capital is Rs. 250,000 divided in to 25,000 shares of Rs. 10 each.
- Provision for Income Tax to be made Rs. 12,500.

Solution:

Balance Sheet

Alpha Ltd.		
Balance Sheet		
As At June 30, 2002		
Particulars	Note	Amount Rs.
Fixed Assets at WDV	1	254,850
Current Assets		
Debtors		46,525
Stock in Trade		68,050
Bank Balance		20,975
		135,550
Current Liabilities		
Creditors		28,425
Proposed Dividend		17,500
Debenture Markup Payable		3,750
Provision for Tax		12,500
		62,175
Working Capital		73,375
Net Assets Employed		328,225
Financed By:		
Authorized Capital 25,000 Shares of Rs. 10 each		250,000
Paid Up Capital 17,500 shares of Rs. 10 each		175,000
Share Premium		35,000
General Reserve (12,500 + 5,000 transferred from P & L)		17,500
Accumulated Profit and Loss Account		25,725
Share Holders' Equity		253,225
Debentures		75,000
Total		328,225

Profit & Loss Account

Alpha Ltd		
Profit and Loss Account		
For the Year Ended June 30 2002		
Particulars	Note	Rs.
Sales		245,500
Less: Cost of Goods Sold	2	127,500
Gross Profit		118,000
Less: Administrative Expenses		
Directors Remuneration		15,750
Salaries and Wages		23,100
Vehicle Running Expenses		20,300
Insurance		7,325
Depreciation	1	15,500
Miscellaneous Expenses		1,400
		83,375
Operating Profit		34,625
Less: Debenture Markup	3	7,500
Net Profit Before Tax		27,125
Less: Provision for Tax		12,500
Net Profit after tax		14,625
Add: Accumulated Profit Brought Forward		42,350
		56,975
Less: Appropriation		
General Reserve		5,000
Interim dividend		8,750
Proposed Final Dividend (10% of 175,000)		17,500
		31,250
Accumulated Profit Carried Forward		25,725

Note # 1 Fixed Asset at WDV

Particulars	Cost			R A T E	Acc. Dep.			WDV
	As At 1-7-01	Addition/ Deletion	As At 30-6-02		As At 1-7-01	For The Year	As At 30-6-02	As At 30-6-02
Building	237,500	0	237,500		11,250	5,000	16,250	221,250
Equipment	20,000	0	20,000		6,000	3,000	9,000	11,000
Vehicles	43,000	0	43,000		12,900	7,500	20,400	22,600
TOTAL	300,500	0	300,500		30,150	15,500	45,650	254,850

Note # 2 Cost of Goods Sold

Opening Stock	56,725
Add: Purchases	134,775
Add: Carriage inward	4,050
Less: Closing Stock	<u>(68,050)</u>
	<u>127,500</u>

Note # 3 Mark up on Debentures

Mark up given in trial		3,750
Add: Accrued Mark up for six months	(75,000 x 10% x 6/12)	<u>3,750</u>
Total Mark Up		7,500

Statement of Changes in Equity

Statement of changes in equity shows movement in share holders' equity during the reported period.

Share holders equity includes:

- Share Capital
- Share Premium Reserve
- General Reserve
- Accumulated Profit & Loss Account

Types of Reserves

Reserves are of two types:

- Distributable Reserve
- Non Distributable Reserve

Distributable Reserve

Distributable reserves are those reserves which are distributable among the share holders of the company, for Example, General Reserve, Accumulated Profit & loss etc.

Non Distributable Reserve

Non Distributable reserves are those reserves which are created for a specific purpose. These can not be distributed among share holders. These can be utilized for that particular purpose, for which, these are created. For example, Share Premium Reserve, Revaluation Reserve.

Procedure for Preparing Statement of Change in Equity

All the opening balances of share holders' equity are listed down first. Movement during the year in share holders' equity is recorded. After adding/reducing the share holders' equity, closing balances are calculated. All information regarding share holders' equity is collected from balance sheet of the company. According to International Accounting Standards, fixed assets revaluation reserve is included in the statement of changes in equity. But The Companies Ordinance does not allow revaluation reserve to become a part of statement of changes in equity. As Companies Ordinance prevails over International Accounting Standards, so we do not show Revaluation reserve in the statement of changes in equity.

Statement of Change in Equity

Alpha Ltd					
Statement of Changes in Equity For Year Ended June 30, 2002					
	Share Capita l	Share Premiu m Account	General Reserv e	Profit & Loss A/c	Total
Balance On Jun 30, 2001	175,000	35,000	12,500	42,350	264,850
Net Profit for the Period				14,625	14,625
Transfer to General Reserve			5,000	(5,000)	0
Dividend				(26,250)	(26,250)
Balance On June 30, 2002	175,000	35,000	17,500	25,725	253,225

Notes to the Accounts

Notes to the accounts are explanatory notes on financial statements of the company. These include all the information, from formation of company to the calculation of figures, arrived at, during the preparation of financial statements.

Notes of Alpha Ltd. are as follows:

- **Company and Its operations**
 - Company was formed in the year -----
 - The company trades in electronic consumer items.

Significant Accounting Policies:

Historical Cost Convention

- These accounts have been prepared under the historical cost convention.

Revenue Recognition

- Sales are recorded on dispatch of goods to customers.

Fixed Assets

- Fixed Assets are recorded at cost less accumulated depreciation.

Stock Valuation

- Method of stock valuation is -----

Taxation

- Provision for Taxation is calculated on the basis of -----

Lesson-41**CASH FLOW STATEMENT**

Cash flow statement shows, how cash was generated and how it was used during the period. These days, it is required by law to include this statement in financial statements, especially in case of financial statements of limited companies.

Need For Cash Flow Statement

For any business, it is important to ensure that:

- Sufficient profits are made to compensate owners for the investment made, efforts put in and the risk taken for the business,
- Sufficient funds are available to meet the obligations of the business as and when required.

The information as to profitability is provided by the Profit and Loss Account. The information as to availability of funds or financial health is provided by the balance sheet. But the balance sheet is prepared on a specific date and can provide information of financial position as on that date only. Cash flow, on the other hand provides more detailed information about the movement of funds during the period. With the help of cash flow, we can determine the amount of cash generated from different sources and the areas on which it is utilized.

Difference between Profitability and Liquidity**Liquidity**

It is the ability of a business to pay its debts in time. By having good liquidity, we mean that a business has sufficient liquid funds (cash and cash equivalents) so that it can repay liabilities.

Cash

Cash includes cash in hand and demand deposits.

Cash Equivalents

Cash equivalents are those short term investments that can be converted into a known amount of cash at any time. Usually, investments up to three months maturity are included in cash equivalents.

People generally mix up profitability with liquidity. One might think that if a business has earned, say, One Million Rupees of profit than it should have approximately the same amount of cash in it.

But mostly this is not the case. Consider the following example:

- A person starts a small business with Rs. 10,000.
- He purchases goods worth Rs. 20,000. Rs. 10,000 is paid in cash and remaining is payable at the end of the month.
- The same day, all the goods are sold on credit of two months for Rs. 30,000.
- Now if we draw a profit and loss account at the end of the month, the business has earned a profit of Rs. 10,000, considering no expenses.
- But at the same time, it is time to pay to the Creditors, whereas payment from debtor is not due yet.
- This means that although the business earned a profit of Rs. 10,000 but it has no cash to pay to its creditors.
- This simple example helps us to understand that liquidity is different from profitability
- But it is as important as profitability.

Components of Cash Flow Statement

Cash flow statement is divided into three components

- Cash Flow from Operating Activities
- Cash Flow from Investing Activities
- Cash Flow from Financing Activities

Cash Flow from Operating Activities

Cash flow from operating activities is generally derived from the principal revenue producing activities of the business.

Cash Flow from Operating Activities is the indicator of success or failure of a business's operations. If the cash flow from operations is continuously negative, this means that the business revenue is not enough to recover the costs that are incurred to earn it. Therefore, in the long run Cash flow from operations must be positive.

Examples of cash flows from operating activities are:

- Cash receipt from sale of goods and rendering of services.
- Cash receipts from fees, commission and other revenues.
- Cash payments to suppliers for goods and services.
- Cash payments to and on behalf of the employees.
- Cash payments or refunds of income taxes.

Example

Net Profit before Tax	16,514
Add: Adjustment for Non-Cash Items	
Depreciation for the Year	5,500
Provision for Doubtful Debts	810
Exchange Gain / Loss	-
Gain / Loss on Disposal of Assets	-
Return on Investments	4,000
Mark-up on Loans	3,500
Operating Profit Before Working Capital Changes	30,324
Working Capital Changes	
Add: Decrease in Current Assets	40,000
Less: Increase in Current Assets	(50,000)
Add: Increase in Current Liabilities	-
Less: Decrease in Current Liabilities	-
Cash Generated From Operations	20,324
Less: Markup paid on loans	(3,000)
Less: Taxes Paid	<u>(5,000)</u>
Net Cash Flow from Operating Activities	12,324

Cash Flow from Investing Activities

Cash flow from investing activities includes cash receipts and payments that arise from Fixed and Long Term assets of the organization.

Cash Flows from Investing Activities shows the investment trend of the business. If it is negative (Outflow) this means that the company is investing in long term assets and is expanding. On the other hand if it is positive (Inflow) over the years, this means that the company is selling its long term investments.

Examples of cash flows from investing activities are:

- Cash payments to acquire property plant and equipment. These also include payments made for self-constructed assets.
- Cash receipts from sale of property plant and equipment.
- Cash payments and receipts from acquisition and disposal of other than long term assets e.g. Shares, debentures, TFC, long term loans given etc.

If assets are held for trading purposes or in normal course of business e.g. car / property dealers and loans given by banks, then cash flow from these are included in Operating Cash Flow.

Example

Cash Flow from Investing Activities

Add: Disposal of Fixed Asset and Long Term Investments	100,000
Less: Acquisition of Fixed Assets and Long Term Investments	(80,000)
Add: Dividend Received / Returns on Investment Received	-
Net Cash Flow from Investing Activities	20,000

Cash Flow from Financing Activities

Cash flow from financing activities includes cash receipts and payments that arise from Owners of the business and other long term liabilities of the organization.

Cash Flows from Financing Activities shows the behavior of investors (both equity capital and debt capital). A positive figure (inflow) shows that funds are being invested in the company and vice versa.

Examples of cash flows from financing activities are:

- Cash received from owners i.e. share issue in case of company and capital invested by sole proprietor or partners.
- Cash payments to owners i.e. dividend, drawings etc.
- Cash receipts and payments for other long term loans and borrowings.

Example

Cash Flow from Financing Activities

Add: Shares Issued / Capital Invested	1,000,000
Less: Dividend Paid / Drawings	(400,000)
Add: Increase in Long Term Borrowings	150,000
Net Cash Flow from Financing Activities	750,000

Procedure of Preparing Cash Flow

Cash Flow Statement is prepared as follows:

- We start from the Profit / Loss for the period before taxation.
- Adjustments are made for non-cash items that are included in the profit and loss account such as Depreciation, Provisions and other items that relate to investing and financing activities.
- This gives us Operating Profit before Working Capital Changes.

- Then Working Capital Changes, i.e. increase or decrease in items of current assets and liabilities, are added / subtracted (Cash and Cash Equivalents are not included here)
- This gives the Cash Flow from Operations.
- To this figure, we add / subtract cash flows from investing and financing activities.
- This gives us Net Increase / Decrease in Cash and Cash Equivalents.
- To this figure we add Opening Balance of Cash and Cash Equivalents (that we excluded from current assets)
- This gives us the Closing Balance of Cash and Cash Equivalents.

Increase or Decrease is generally taken as difference in opening and closing balances of accounts reported in balance sheets.

Form of Cash Flow Statement

Name of the Entity Cash Flow Statement for the Period Ending -----

Net Profit before Tax	XYZ
Add: Adjustment for Non-Cash Items	
Depreciation for the Year	XYZ
Provision for Doubtful Debts	XYZ
Exchange Gain / Loss	XYZ
Gain / Loss on Disposal of Assets	XYZ
Return on Investments	XYZ
Mark-up on Loans	XYZ
Operating Profit before Working Capital Changes	XYZ
Working Capital Changes	
Add: Decrease in Current Assets	XYZ
Less: Increase in Current Assets	(XYZ)
Add: Increase in Current Liabilities	XYZ
Less: Decrease in Current Liabilities	(XYZ)
Cash Generated From Operations	XYZ
Less: Markup paid on loans	(XYZ)
Less: Taxes Paid	(XYZ)
Net Cash Flow from Operating Activities	XYZ
Cash Flow from Investing Activities	
Add: Disposal of Fixed Asset and Long Term Investments	XYZ
Less: Acquisition of Fixed Assets and Long Term Investments	(XYZ)
Add: Dividend Received / Returns on Investment Received	XYZ
Net Cash Flow from Investing Activities	XYZ
Cash Flow from Financing Activities	
Add: Shares Issued / Capital Invested	XYZ
Less: Dividend Paid / Drawings	(XYZ)
Add: Increase in Long Term Borrowings	XYZ
Net Cash Flow from Financing Activities	XYZ
Net Increase / Decrease in Cash and Cash Equivalents	XYZ
Add: Opening Balance of Cash and Cash Equivalents	XYZ
Closing Balance of Cash and Cash Equivalents	XYZ

Lesson-42**CASH FLOW STATEMENT (Continued)****Question # 1**

You are given the Balance Sheet of ABC Limited as at June 30, 2001 and June 30, 2002 and its Profit and Loss Account for the year ended June 30 2002.

Required

You are required to prepare Cash Flow Statement for the given period.

ABC Ltd
Balance Sheet As At June 30 2002

	2002 Rs. Rs. '000	2001 Rs. Rs. '000
Building at Cost	181,000	140,000
Accumulated Depreciation	<u>36,000</u>	<u>30,000</u>
Written Down Value	145,000	110,000
Plant and Machinery cost	83,000	90,000
Accumulated Depreciation	<u>36,000</u>	<u>35,000</u>
Written Down Value	<u>47,000</u>	<u>55,000</u>
Total Fixed Assets at WDV	192,000	165,000
Long Term Investment	17,000	10,000
Current Assets		
Debtors	30,000	21,000
Stock	25,000	40,000
Short Term Deposits	18,000	15,000
Cash and Bank	<u>30,000</u>	<u>24,000</u>
	103,000	100,000
Current Liabilities		
Creditors	15,000	12,000
Proposed Dividend	18,000	16,000
Tax Payable	<u>9,000</u>	<u>8,000</u>
	<u>42,000</u>	<u>36,000</u>
Working Capital	61,000	64,000
Net Assets Employed	270,000	239,000
Financed By		
Share Capital	180,000	160,000
Share Premium Account	17,000	12,000
General Reserve	23,000	20,000
Accumulated Profit and Loss	34,000	27,000
Share Holders' Equity	254,000	219,000
Term Finance Certificates	<u>16,000</u>	<u>20,000</u>
Total	270,000	239,000

ABC Ltd
Profit and Loss Account For the Year Ended June 30 2002

	Rs. '000
Sales	300,000
Cost of Sales	(231,000)
Gross Profit	69,000
Other Income	4,000
	73,000
Less: Administrative Expenses	
Director's Remuneration	4,000
Depreciation on Building	6,000
Loss on Sale of Machinery	2,000
Other Administrative Expenses	12,000
	24,000
Less: Selling Expenses	10,000
Less: Mark up on TFC	2,000
	36,000
Profit for the Year Before Tax	37,000
Provision for tax	9,000
Profit after tax	28,000
Acc. Profit Brought Forward	27,000
	55,000
Appropriation	
Transfer to Reserve	3,000
Proposed Dividend	18,000
	21,000
Accumulated Profit Carried Forward	34,000

Additional Information

1. Other income include dividend on Long Term Investment
2. Cost of goods sold includes depreciation for the year on machinery Rs. 5,000.
3. Accumulated Depreciation on the machine disposed off amounts to Rs. 4,000.

Solution

ABC Ltd		
Cash Flow Statement For the Year Ended June 30 2002		
	Note	Rs. '000
Net Profit Before Tax		37,000
Adjustment of Non Cash Items		
Depreciation		11,000
Loss on Sale of Machinery		2,000
Markup on TFC		2,000
		52,000
Less: Other Income		(4,000)
Operating Profit Before Working Capital Changes		48,000
Working Capital Changes		
Reduction in Stock		15,000
Increase in Creditors		3,000
Increase in Debtors		(9,000)
		9,000
Cash Flow from Operations		57,000
Markup on TFC Paid		(2,000)
Tax Paid	1	(8,000)
Net Cash Flow From Operating Activities		47,000
Cash Flow From Investing Activities		
Dividend Received		4,000
Payment to Acquire Investments	2	(7,000)
Purchase of Fixed Assets (Building)	3	(41,000)
Receipt from Sale of Assets	4	1,000
Net Cash Flow From Investing Activities		(43,000)
Cash Flow From Financing Activities		
Issue of Ordinary Shares		20,000
Share Premium Account		5,000
Dividend Paid	5	(16,000)
Repayment of TFC	6	(4,000)
Net Cash Flow From Financing Activities		5,000
Net Increase / (Decrease) in Cash and Cash Equivalents During The Year		9,000
O/B of Cash and Cash Equivalents		39,000
C/B of Cash and Cash Equivalents		48,000

Note # 1 Tax Paid

Provision for Tax		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Cash	8,000	Bal. B/F	8,000
Balance c/f	9,000	For the year	9,000
Total	17,000	Total	17,000

Note # 2 Payments to Acquire Investments

Investment		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Bal. B/F	10,000		
Cash	7,000	Bal. C/F	17,000
Total	17,000	Total	17,000

Note # 3 Purchases of Fixed Assets

Building Cost		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Bal. B/F	140,000		
Cash	41,000	Bal. C/F	181,000
Total	181,000	Total	181,000

Note # 4 Sale Proceed of Machinery

Machinery at Cost		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Bal. B/F	90,000	Disposal A/c	7,000
		Bal. C/F	83,000
Total	90,000	Total	90,000

Disposal of asset		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Cost	7,000	Accumulated Dep.	4,000
		Loss on Sale	2,000
		Sale Proceed	1,000
Total	7,000	Total	7,000

Note # 5 Dividend Payable

Dividend Payable		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Cash	16,000	O/B	16,000
		For the Year	18,000
C/B	18,000		
Total	34,000	Total	34,000

Note # 6 Repayment of TFC

TFC Account		Account Code -----	
Particulars	Amount Dr. (Rs.)	Particulars	Amount Cr. (Rs.)
Cash	4,000	O/B	20,000
C/B	16,000		
Total	20,000	Total	20,000

Lesson-43**FINANCIAL STATEMENTS OF LISTED/QUOTED COMPANIES**

According to Companies Ordinance 1984, the contents of financial statements are as follows:

- Balance Sheet
- Profit and Loss Account
- Cash Flow Statement
- Statement of changes in Equity
- Notes to the Accounts

For the sake of presentation same order should be followed while solving the questions. But we cannot complete the balance sheet without first preparing the Profit and Loss Account. To solve the problem in exam situation we usually prepare the forms of Balance Sheet and Profit and Loss Account first. That is way we can also plan the Serial Numbers of Notes to the Accounts beforehand. Otherwise a sheet of question paper can be left blank for preparation of Balance Sheet.

Comparative figures are also included in the financial statements for every figure, except where first set of financial statements is being prepared. In examination situation comparative figures should be shown provided these are provided in the question.

Question

Following is the trial balance of Alfa Ltd. For the year ended June 30, 2002. You are also given the balance sheet of June 30, 2001.

Required

You are required to prepare a set of financial statements of the Alfa Ltd.

Alfa Ltd.
Trial Balance
For the Year June 30, 2002

	Debit Rs.	Credit Rs.
Fixed Assets at Cost		
Freehold Land	500,000	
Building	600,000	
Furniture and Fixture	400,000	
Vehicles	930,000	
Accumulated Depreciation		
Building		150,000
Furniture and Fixture		150,000
Vehicles		300,000
Sundry Debtors	80,000	
Advances, Deposits and Prepayments	26,000	
Investments (Long Term)	105,000	
Cash in hand	2,000	
Cash at bank	75,500	
Purchases	500,000	
Sales Return	10,000	
Stock July 01, 2001	85,000	
Salaries (Admin. Staff)	65,000	
Rent, Rates and Taxes	12,500	

Carriage inward	8,000	
Legal Charges	7,500	
Salaries (Sales Staff)	45,000	
Selling Expenses	23,000	
Financial Charges	45,000	
Sundry Creditors		50,500
Short Term Running Finance		175,000
Advances from Customers		28,500
General Reserve		250,000
Tax Payable		35,500
Accumulated Profit Brought Forward		90,000
Sales		857,200
Markup on Investments		15,000
Purchase Return		12,800
Loan from Bank (Long Term)		655,000
Issued Share Capital		750,000
Total	3,519,500	3,519,500

Additional information:

- The authorized capital of the company is Rs. 1,000,000 divided into 100,000 shares of Rs. 10 each.
- Additions made in Fixed Assets include Building Rs. 75,000 and Furniture and Fixture Rs. 50,000. These have already been recorded in the books of accounts.
- Depreciation is to be charged on Building 5%, Furniture and Fixture @ 10% and Vehicles 20% on written down value. Full year's depreciation is charged in the year of purchase whilst no depreciation is charged in the year of disposal.
- Provision for doubtful debts to be created Rs. 5,000.
- Stock on June 30, 2002 Rs. 65,000
- Provide Rs. 9,800 for income tax.

Alfa Ltd.		
Balance Sheet		
As at June 30, 2001.		
	Note	2001
Operating Fixed Assets		1,705,000
Investments		55,000
		1,760,000
Current Assets		
Sundry Debtors		65,900
Stock in Trade		85,000
Advances, Deposits and Prepayments		21,500
Cash in hand		1,500
Cash at bank		58,600
		232,500
Current Liabilities		
Sundry Creditors		65,200
Short Term Running Finance		125,500
Tax Payable		42,000

	Advances from Customers		19,800
			252,500
	Working Capital		(20,000)
	Net Capital Employed		1,740,000
	Financed by		
	Share Capital and Reserves		
	Authorized Capital		
	100,000 shares of Rs. 10 each.		1,000,000
	Share Capital		
	75,000 (2001: 60,000) shares of Rs. 10 each		600,000
	General reserve		250,000
	Un-appropriated Profit		90,000
	Total Share holders Equity		940,000
	Long Term Loans		800,000
	Total		1,740,000

Solution

Alfa Ltd.				
Balance Sheet				
As at June 30, 2002.				
	Note	2002		2001
Operating Fixed Assets	1	1,656,500		1,705,000
Investments		105,000		55,000
		1,761,500		1,760,000
Current Assets				
Sundry Debtors		80,000		65,900
Stock in Trade		65,000		85,000
Advances, Deposits and Prepayments		26,000		21,500
Cash in hand		2,000		1,500
Cash at bank		75,500		58,600
		248,500		232,500
Current Liabilities				
Sundry Creditors		50,500		65,200
Short Term Running Finance		175,000		125,500
Tax Payable	2	45,300		42,000
Advances from Customers		28,500		19,800

			299,300		252,500
Working Capital			(50,800)		(20,000)
Net Capital Employed			1,710,700		1,740,000
Financed by					
Share Capital and Reserves					
Authorized Capital					
100,000 shares of Rs. 10 each.			1,000,000		1,000,000
Share Capital					
75,000 (2001: 60,000) shares of Rs. 10 each			750,000		600,000
General reserve			250,000		250,000
Un-appropriated Profit			55,700		90,000
Total Share holders Equity			1,055,700		940,000
Long Term Loans			655,000		800,000
Total			1,710,700		1,740,000

Profit & Loss Account

Alfa Ltd.				
Profit and Loss Account				
For the year ended June 30, 2002.				
	Note	2002		2001
		Rs.		Rs.
Net Sales	3	847,200		x
Less: Cost of Goods Sold	4	515,200		x
Gross Profit		332,000		x
Add: Other Income		15,000		x
		347,000		x
Less:				
Administrative Expenses	5	258,500		x
Selling Expenses	6	68,000		x
		326,500		x
Operating Profit		20,500		x
Less: Financial Charges		45,000		x
Net Profit / (Loss) Before Tax		(24,500)		x
Less: Provision for Tax		9,800		x
Net Profit / (Loss) After Tax		(34,300)		x
Accumulated Profit / (Loss) Brought Forward		90,000		x
Accumulated Profit / (Loss) Carried Forward		55,700		x

Alfa Ltd.				
Cash Flow Statement				
For the year ended June 30, 2002				
	Note	2002		2001
Cash Flow From Operating Activities				
Profit / (Loss) Before Tax		(24,500)		
Adjustment for: Depreciation		173,500		
Operating Profit Before Working Capital changes		149,000		
(Increase) / Decrease in C. Assets				
Sundry Debtors		(14,100)		
Stock in Trade		20,000		
Advances, Deposits and Prepayments		(4,500)		
		1,400		
Increase / (Decrease) in C. Liabilities				
Sundry Creditors		(14,700)		
Short Term Running Finance		49,500		
Advances from Customers		8,700		
		43,500		
Cash Generated From Operations		193,900		
Income Tax Paid		(6,500)		
Net Cash Flow from Operations		187,400		
Cash Flow From Investing Activities				
Building		(75,000)		
Furniture and Fixture		(50,000)		
Investments (Long Term)		(50,000)		
Net Cash Flow From Investing Activities		(175,000)		
Cash Flow from financing Activities				
Share Capital Issued		150,000		
Long Term Loan Repaid		(145,000)		
		5,000		
Net Increase in Cash & Cash Equivalent		17,400		
O/B of Cash and Cash Eq.		60,100		
C/B of Cash and Cash Eq.		77,500		

Alfa Ltd.				
Statement of Changes in Equity				
For the Year Ended June 30, 2002				
Particulars	Share	General	Un-app.	Total
	Capital	Reserve	Profit	
Balance as on June 30, 2000	x	x	x	x
Profit after tax for the year			x	x
Dividend			(x)	(x)
Balance as on June 30, 2001	600,000	250,000	90,000	940,000
Shares Issued	150,000			150,000
Profit after tax for the year			(34,300)	34,300
	750,000	250,000	55,700	1,055,700

Notes to the Accounts

Note # 1 Fixed Assets at WDV

Particulars	Cost			R	Accumulated Depreciation			WDV	
	As On			A	As On	On	For	As On	As On
	Jul 01	Add.	Disposal.	T	Jul 01	Disposal.	The	Jun 01	Jun 01
	2001			E	2001		Year	2002	2002
Freehold Land	500,000	-	-	-	-	-	-	-	500,000
Building	525,000	75,000	-	5	150,000	-	22,500	172,500	427,500
Furniture and Fixture	350,000	50,000	-	10	150,000	-	25,000	175,000	225,000
Vehicles	930,000	-	-	20	300,000	-	126,000	426,000	504,000
Total 2002	2,305,000	125,000	-	2,430,000	600,000	-	173,500	773,500	1,656,500
Total 2001	x	x	x	2,305,000	x	x	x	600,000	1,705,000

Note # 2 Tax Payable

Tax Payable as Per Trial Balance	35,500
Current Year's Provision	9,800
	45,300

Note # 3 Net Sales

Gross Sales	857,200
Less: Returns	10,000
	<hr/>
	847,200

Note # 4 Cost of Goods Sold

Opening Stock	85,000
Add: Cost of Material Purchased	
Gross Purchases	500,000
Less: Returns	12,800
Add: Carriage Inward	8,000
	495,200
Less: Closing Stock	65,000
	<hr/>
Cost of goods sold	515,200

Note # 5 Administrative Expenses

Salaries (Admin. Staff)	65,000
Rent, Rates and Taxes	12,500
Legal Charges	7,500
Depreciation	173,500
	<hr/>
Total	258,500

Note # 6 Selling Expenses

Salaries (Sales Staff)	45,000
Selling Expenses	23,000
	<hr/>
Total	68,000

Lesson-44**FINANCIAL STATEMENTS OF LISTED COMPANIES**

Illustration:

Beta Ltd.		
Trial Balance		
For the Year June 30, 2002		
	Debit (Rs.)	Credit (Rs.)
Fixed Assets at Cost:		
Building	500,000	
Furniture and Fixture	85,000	
Vehicles	460,000	
Accumulated Dep: Building		190,500
Furniture and Fixture		43,500
Vehicles		210,000
Sundry Debtors	165,000	
Long Term investments	300,000	
Goodwill	100,000	
Cash in hand	33,000	
Cash at bank	146,000	
Purchases	755,000	
Stock July 01, 2001		
Raw Material	19,000	
Work in Process	14,500	
Finished Goods	35,000	
Salaries	125,000	
Misc. Expense	6,600	
Carriage inward	4,300	
Fuel & Power	15,400	
Wages	143,500	
Salaries Sales Staff	86,000	
Financial Charges	2,300	
Sundry Creditors		105,000
Share Premium Reserve		300,000
Provision for tax payable.		29,500
Accumulated Profit Brought Forward		93,300
Sales		1,363,800
Gain on sale of vehicle		30,000
Return on Investments		30,000
Loan from Bank (Long Term)		100,000
Issued Share Capital		500,000
Total	2,995,600	2,995,600

Additional Information:

- The authorized capital of the company is Rs. 800,000 divided into 80,000 shares of Rs. 10 each.
- During the year, a vehicle whose cost and accumulated depreciation were Rs. 150,000 and Rs. 80,000 respectively was sold for Rs. 100,000. The entry has already been recorded in the books
- Depreciation is to be charged on Building 5%, Furniture and Fixture @ 10% and Vehicles 20% on written down value. Full year's depreciation is charged in the year of purchase whilst no depreciation is charged in the year of disposal.
- Stock on June 30, 2002
 - Raw Material 22,000
 - Work in Process 15,000
 - Finished Goods 40,000
- Distribution of fuel and power:
 - Administrative Expenses 40%, Cost of Goods Sold 60%
- The management of the company has decided to maintain a provision for doubtful debts at 5% of debtors from this year.
- Long term loan of Rs. 25,000 is payable in the next financial year.
- Provision for current year's tax Rs. 20,000.

You are required to prepare a set of financial statements for the year ended June 30, 2002.

Solution

Beta Ltd.				
Balance Sheet				
As at June 30, 2002.				
	Note	2002		2001
Operating Fixed Assets	3	531,375		671,000
Investments		300,000		50,000
		831,375		721,000
Intangible Assets				
Goodwill		100,000		100,000
Current Assets				
Sundry Debtors	4	156,750		175,000
Stock in Trade	5	77,000		84,300
Cash in hand		33,000		25,800
Cash at bank		146,000		100,700
		412,750		385,800
Current Liabilities				
Sundry Creditors		105,000		150,500
Current Maturity of Long Term Loan		25,000		25,000
Tax Payable	6	49,500		38,000
		179,500		213,500
Working Capital		233,250		172,300

Net Capital Employed		1,164,625		993,300
Financed by				
Share Capital and Reserves				
Authorized Capital				
80,000 share of Rs. 10 each		800,000		800,000
Share Capital		500,000		500,000
Share premium reserve		300,000		300,000
Un-appropriated Profit		289,625		93,300
Total Share holders Equity		1,089,625		893,300
Long Term Loans	7	75,000		100,000
Total		1,164,625		993,300

Beta Ltd.				
Profit and Loss Account				
For the year ended June 30, 2002.				
	Note	2002		2001
		Rs.		Rs.
Net Sales		1,363,800		x
Less: Cost of Goods Sold	8	903,540		x
Gross Profit		460,260		x
Add: Other Income	9	60,000		x
		520,260		x
Less:				
Administrative Expenses	10	215,635		x
Selling Expenses	11	86,000		x
		301,635		x
Operating Profit		218,625		x
Less: Financial Charges		2,300		x
Net Profit / (Loss) Before Tax		216,325		x
Lees: Provision for Tax		20,000		x
Net Profit / (Loss) After Tax		196,325		x
Accumulated Profit / (Loss) Brought Forward		93,300		x
Accumulated Profit / (Loss) Carried Forward		289,625		x

Alfa Ltd.		
Cash Flow Statement		
For the year ended June 30, 2002		
	Note	2002
Cash Flow From Operating Activities		
Profit / (Loss) Before Tax		216,325
Adjustment for:		
Depreciation		69,625
Provision for Doubtful Debts		8,250
Gain on Disposal of Fixed Asset		(30,000)
Operating Profit Before Working Capital changes		264,200
(Increase) / Decrease in C. Assets		
Sundry Debtors		10,000
Stock in Trade		7,300
		17,300
Increase / (Decrease) in C. Liabilities		
Sundry Creditors		(45,500)
		(45,500)
Cash Generated From Operations		236,000
Income Tax Paid		(8,500)
Net Cash Flow from Operations		227,500
Cash Flow From Investing Activities		
Vehicles		100,000
Investments (Long Term)		(250,000)
Net Cash Flow From Investing Activities		(150,000)
Cash Flow from financing Activities		
Long Term Loan Repaid		(25,000)
		(25,000)
Net Increase in Cash & Cash Equivalents		52,500
O/B of Cash and Cash Equivalents		126,500
C/B of Cash and Cash Equivalents		179,000

Beta Ltd.				
Statement of Changes in Equity				
For the Year Ended June 30, 2002				
Particulars		Share	Un-app.	
	Share	Premium	Profit	Total
	Capital	Reserve		
Balance as on June 30, 2000	x	x	x	x
Profit after tax for the year			x	x
Dividend			(x)	(x)
Balance as on June 30, 2001	500,000	300,000	93,300	893,300
Shares Issued	x			x
Profit after tax for the year			196,325	196,325
	750,000	250,000	289,625	1,089,625

Notes to the Accounts

1. Company and its operations

- The company is a public limited company incorporated in Pakistan and manufacture

2. Significant accounting policies

- These accounts have been prepared in accordance with the requirements of the Companies Ordinance 1984 and International accounting standards as applicable in Pakistan.
- **Historical costs**
 - Historical costs are used as a basis for valuing transactions.
- **Revenue Recognition**
 - Sales are recorded upon delivery of goods to the customers.
- **Other Policies**
 - Income from bank deposits, loans and advances are recognized on accrual basis.
 - Working of all figures and Fixed assets schedule are included in the notes to the accounts

Note # 3 Fixed Assets at WDV

Particulars	Cost				R A T E	Accumulated Depreciation				Rs' 000
	As On	Add.	Disposal.	As On		On	For	As On	WDV	
	Jul 01 2001			Jun 30 2002					Disposal.	The
Building	500,000	-	-	500,000	5	190,500	-	15,475	205,975	294,025
Furniture and Fixture	85,000	-	-	85,000	10	43,500	-	4,150	47,650	37,350
Vehicles	610,000	-	150,000	460,000	20	290,000	80,000	50,000	260,000	200,000
Total 2002	1,195,000	-	150,000	1,045,000		524,000	80,000	69,625	513,625	531,375
Total 2001	x	x	x	1,195,000		x	x	x	524,000	671,000

Note # 4 Sundry Debtors

	2002	2001
Debtors	165,000	175,000
Less: Provision for Doubtful Debts	(8,250)	-
	<u>156,750</u>	<u>175,000</u>

Note # 5 Stock in Trade

Raw Material	22,000	25,000
Work in Process	15,000	16,800
Finished Goods	<u>40,000</u>	<u>42,500</u>
	<u>77,000</u>	<u>84,300</u>

Note # 6 Tax Payable

Tax Payable as Per Trial Balance	29,500	20,000
Current Year's Provision	<u>20,000</u>	<u>18,000</u>
	<u>49,500</u>	<u>38,000</u>

Note # 7 Long Term Loans

Long Term Loan	100,000	125,000
Less: Current Maturity of Long Term Loan	25,000	25,000
	75,000	100,000

Note # 8 Cost of Goods Sold

Opening Stock - Raw Material	19,000
Add: Cost of Material Purchased	
Purchases	755,000
Add: Carriage Inward	4,300
	759,300
Less: Closing Stock - Raw Material	22,000
Raw Material Consumed	756,300
Wages	143,500
Fuel and Power	9,240
	909,040
Add: Opening Stock - Work in Process	14,500
Less: Closing Stock - Work in Process	15,000
	908,540
Add: Opening Stock - Finished Goods	35,000
Less: Closing Stock - Finished Goods	40,000
	903,540

Note # 9 Other Income

Gain on sale of vehicle	30,000
Return on investments	30,000
	60,000

Note # 10 Administrative Expenses

Salaries	125,000
Fuel and Power	6,160
Misc. Expense	6,600
Provision for Doubtful Debts	8,250
Depreciation	69,625
	215,635

Note # 11 Selling Expenses

Salaries (Sales Staff)	86,000
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Lesson-45**FINANCIAL STATEMENTS OF LISTED COMPANIES AND FINANCIAL RATIOS****Question # 1**

Following is the trial balance and balance sheet of Sheraz Ltd. as on June 30, 2002.

Sheraz Ltd.				
Trial Balance				
As On June 30 2002				
			DEBIT	CREDIT
			Rs'000	Rs'000
<u>Tangible Fixed Assets</u>				
<u>Fixed Assts At Cost</u>				
	Freehold Land		9,550	
	Building		15,815	
	Plant and Machinery		54,636	
	Furniture and Fixture		2,698	
	Motor Vehicles		24,111	
	Leased Vehicles		22,123	
<u>Accumulated Dep.</u>				
	Building			10,775
	Plant and Machinery			47,315
	Furniture and Fixture			2,474
	Motor Vehicles			12,347
	Leased Vehicles			12,186
	Capital Work in Progress		4,075	
Long Term Investments				
	Investment in Shares of Co. A		20,000	
	Investment in Shares of Co. B		2,500	
	Prov. For Diminution in Value Co. B			1,250
Long Term Deposits				
	Long Term Deposits		3,069	
<u>Current Assets</u>				
	Stores and Spares		1,114	
	Stock in Trade Jul 01 2001		-	
	Raw Material		13,264	
	Packing Material		42,189	
	Finished goods		85,296	
Trade Debts				
	Trade Debts		18,185	
	Provision for Doubtful Debts			223
Adv. Dep. & Prepayments				
	Advances		2,434	
	Deposits		816	
	Prepayments		1,637	

	Accrued Profit on Bank Dep	388	
	Advance Excise Duty	2,601	
	Sales Tax Refundable	8,492	
	Other Receivables	375	
	Dividend Receivable	25,000	
	Cash and Bank	-	
	Cash in Hand	3,330	
	Cash at Bank - Current	25,024	
	Cash at Bank - Savings	16,521	
Current Liabilities			
	Short Term Running Finance		5,257
	Creditors, Accrued & Other L.		-
	Creditors		63,016
	Customers Deposits		22,571
	Accrued Exp.		22,448
	Other Liabilities		1,826
	Tax Payable		3,858
	Dividends		200
Long Term and Deffered. Lia			
	Deffered. Tax		3,000
	Oblig. Under Lease Finance		15,282
Share Capital			50,000
	General Reserve		104,000
Sales			-
	Gross Sale - Domestic		751,244
	Gross Sale - Export		93,305
	Sales Tax	106,158	
Cost of Sales			
	Purchases. During the Year Raw M	291,569	
	Purchases. During the Year Packing M	190,295	
	Overheads		
	Wages	23,155	
	Stores Consumed	7,922	
	Traveling and Conveyance.	158	
	Repairs and Maintenance.	10,267	
	Insurance	345	
	Fuel and Power	23,339	
	Bottle Breakage	6,552	
	Excise Duty	49,671	
	Misc. Expenses	7,412	
Admin. Expenses			-
	Salaries and Wages	36,117	
	Postage and Telegram	1,652	
	Traveling and Conveyance	1,075	

	Repairs and Maintenance.	1,272	
	Insurance	1,179	
	Printing and Stationery	1,121	
	Rent, Rates and Taxes	1,155	
	Auditors' Remuneration	161	
	Legal and Professional	768	
	Donations	81	
	General Expenses	400	
	Selling and Distribution Expenses	-	
	Salaries and Wages	23,227	
	Postage and Telegram	1,578	
	Traveling and Conveyance	2,616	
	Repairs and Maintenance.	6,168	
	Vehicle Running	859	
	Printing and Stationery	497	
	Rent, Rates and Taxes	1,954	
	Advertising	19,254	
	Outward Freight	9,628	
	Sales Staff Incentives	1,642	
	Petrol, Oil etc.	8,561	
	Misc. Expenses	1,392	
	Financial Charges	-	
	Markup on Loans	282	
	Finance Lease Charges	1,750	
	Bank Charges	825	
	Other Expenses and Provisions	-	
	Other Income		-
	Profit on Bank Deposits		974
	Dividends Income		25,100
	Foreign Exchange Gain		5,732
	Gain on Disposal of F. Assts.		692
	Sale of Scrap		1,470
	Income Tax for the year	14,800	
	Unappropriated Profit B/F		5,555
		1,262,100	1,262,100

Adjustments

1. Provision for diminution in the value of investments to be increased to Rs. 1,875.
2. Long term deposits maturing during the year Rs. 291
3. Provision for doubtful debts to be increased by Rs. 987
4. 60% Dividend declared.
5. Liability against lease finance payable in current year Rs. 6,643
6. Authorized capital of 10,000,000 shares of Rs. 10 each.
7. Transfer to general reserve 21,000
8. Addition in Fixed Assets, Plant and Mach. 2,262

9. Furniture 989, Owned vehicles 1758
10. Cash received on disposal of vehicles Rs. 1,316
11. Dep. Building 10% Plant and Furniture 15% and Vehicles 20% on written down value
12. No depreciation on year of sale and full depreciation in the year of purchase.
13. Distribution of Depreciation
 - Building and Plant to Cost of Sales
 - Furniture and Owned Vehicles to Admin Expenses
 - Leased Vehicles to Selling Expenses
14. Closing Stocks

Raw Material	27,545
Packing Material	74,731
Finished Goods	78,550

Sheraz Ltd.		
Balance Sheet		
As At June 30, 2001		
	Note	2001
		Rs'000
Tangible Fixed Assets		
Operating Fixed Assets		39,451
Capital Work in Progress		-
Long Term Investments		21,250
Long Term Deposits		2,004
		62,705
Current Assets		
Stores and Spares		1,405
Stock in Trade		188,639
Trade Debts		24,984
Adv. Dep. And Prepayments		8,826
Cash and Bank Balances		24,437
		248,291
Current Liabilities		
Short Term Running Finances		3,111
Current Maturity of Obligation		
Under lease finance		3,425
Creditors, Accrued and Other		
Liabilities		99,109
Tax Payable		5,472
Divided Payable		30,164
		141,281
Working Capital		107,010
Total Capital Employed		169,715
Financed By		
Share Capital and Reserves		
Share Capital		50,000
General Reserve		104,000
Un appropriated Profit		5,555
Shareholders Equity		159,555

Long Term Liabilities	
Deferred Taxation	3,000
Obligation under Lease Finance	7,160
	10,160
TOTAL	169,715

Required:

Prepare a set of financial statements as on June 30, 2002.

Solution

Sheraz Ltd.				
Balance Sheet				
As At June 30, 2002				
			2002	2001
	Note		Rs'000	Rs'000
Tangible Fixed Assets				
Operating Fixed Assets	3		37,859	39,451
Capital Work in Progress			4,075	-
Long Term Investments	4		20,625	21,250
Long Term Deposits	5		2,778	2,004
			65,337	62,705
Current Assets				
Stores and Spares			1,114	1,405
Stock in Trade	6		180,826	188,639
Trade Debts	7		16,975	24,984
Adv. Dep. And Prepayments	8		42,034	8,826
Cash and Bank Balances	9		44,875	24,437
			285,824	248,291
Current Liabilities				
Short Term Running Finances			5,257	3,111
Current Maturity of Obligation				
under lease finance	13		6,643	3,425
Creditors, Accrued and Other				
liabilities	10		109,861	99,109
Tax Payable			3,858	5,472
Divided Payable	11		30,200	30,164
			155,819	141,281
Working Capital			130,005	107,010
Total Capital Employed			195,342	169,715
Financed By				
Share Capital and Reserves				
Share Capital	12		50,000	50,000
General Reserve			125,000	104,000
Un-appropriated Profit			8,703	5,555
Shareholders Equity			183,703	159,555

Long Term Liabilities				
	Deferred Taxation		3,000	3,000
	Obligation under Lease Finance	13	8,639	7,160
			11,639	10,160
			195,342	169,715

Sheraz Ltd.

**Profit and Loss Account
For the Year Ended June 30, 2002**

			2002	2001
		Note	Rs'000	Rs'000
	Sales	14	738,391	X
	Cost of Sales	15	572,210	X
	Gross Profit		166,181	X
	Other Income	16	33,968	X
	Less: Administrative Expenses	17	48,980	X
	Selling and Distribution Expenses	18	79,364	X
			128,344	X
	Profit From Operations		71,805	X
	Less: Financial Charges	19	2,857	X
	Net Profit Before Taxation		68,948	X
	Income Tax for the Year		14,800	X
	Profit After Taxation		54,148	X
	Un-appropriated Profit Brought Forward		5,555	X
			59,703	X
	Appropriation			
	Transfer to Reserve		21,000	X
	Proposed dividend @ 60%		30,000	X
			51,000	X
	Un-appropriated Profit Carried Forward		8,703	X

Sheraz Ltd.
Cash Flow Statement,
For the Year Ended June 30, 2002

	Note	2002 Rs'000
Cash Flow From Operating Activities		
Profit Before Tax		68,948
Adjustment for:		
Depreciation		5,977
Provision for Doubtful Debts		987
Provision for Diminutions in Value of Investment		625
Profit on Bank Deposits		(974)
Dividends Income		(25,100)
Gain on Disposal of F. Assts.		(692)
		(19,177)
Operating Profit Before Working Capital changes		49,771
(Increase) / Decrease in C. Assets		
Stores and Spares		291
Stock in Trade		7,813
Trade Debts		7,122
Adv. Dep. And Prepayments		(7,989)
		7,237
Increase / (Decrease) in C. Liabilities		
Short Term Running Finances Creditors, Accrued and Other liabilities		2,146
		10,752
		12,898
Cash Generated From Operations		69,906
Profit on Bank Deposits		(974)
Income Tax Paid		(5,100)
Net Cash Flow from Operations		63,832

Cash Flow From Investing Activities	
Purchase of Fixed Assets	(5,009)
Capital Work in Progress	(4,075)
Sale Proceeds Of Fixed Assets	1,316
Dividend Received	100
Long Term Deposits	(1,065)
	(8,733)
Cash Flow from financing Activities	
Repayment of Lease Liability	(4,697)
dividend Paid	(29,964)
	(34,661)
Net Increase in Cash & Cash Equivalents	20,438
O/B of Cash and Cash Equivalents	24,437
C/B of Cash and Cash Equivalents	44,875

Sheraz Ltd.
Statement of Changes in Equity
For the Year Ended June 30, 2002

	Share Capital	General Reserve	Un-app. Profit	Total
Balance as on June 30, 2000	50,000	104,000	4,119	158,119
Profit after tax for the year			31,436	31,436
Dividend			(30,000)	(30,000)
Balance as on June 30, 2001	50,000	104,000	5,555	159,555
Profit after tax for the year			54,148	54,148
Transfer to reserve		21,000	(21,000)	-
Dividend			(30,000)	(30,000)
Balance as on June 30, 2002	50,000	125,000	8,703	183,703

Notes to the Accounts**1. Company and its operations**

The company is a public limited company incorporated in Pakistan and manufacture -----

2. Significant accounting policies

These accounts have been prepared in accordance with the requirements of the Companies Ordinance 1984 and International accounting standards as applicable in Pakistan.

Historical costs

Historical costs are used as a basis for valuing transactions.

Revenue Recognition

Sales are recorded upon delivery of goods to the customers. However Exported goods are considered sold when shipped on board.

Other Policies

- Income from bank deposits, loans and advances are recognized on accrual basis.
- Dividend income is recognized when right to receive is established.
- Research and development casts are expensed as and when incurred.
- Working of all figures, fixed assets schedule and all agreements. I.e. Lease agreements and agreements for obtaining loan from banks are included in the notes to the accounts.

Fixed Assets Schedule

Particulars	Cost				R A T E	Accumulated Depreciation				WDV
	As On Jul 01 2001	Add.	Disposal.	As On Jun 30 2002		As On Jul 01 2001	On Disposal.	For The Year	As On Jun 01 2002	As On Jun 01 2002
Company Owned Assets										
Freehold Land	9,550			9,550		-	-	-	-	9,550
Building	15,815			15,815	10	10,775	-	504	11,279	4,536
Plant and Machinery	52,374	2,262		54,636	15	47,315	-	1,098	48,413	6,223
Furniture and Fixture	1,709	989		2,698	15	2,474	-	34	2,508	190
Vehicles	24,881	1,758	(2,528)	24,111	20	14,251	(1,904)	2,353	14,700	9,411
	104,329	5,009	(2,528)	106,810		74,815	(1,904)	3,989	76,900	29,910

Leased Assets

Vehicles	22,123			22,123	20	12,186		1,988	14,174	7,949
	22,123	-	-	22,123		12,186	-	1,988	14,174	7,949
Total 2002	126,452	5,009	(2,528)	128,933		87,001	(1,904)	5,977	91,074	37,859
Total 2001	x	x	x	x		x	x	x	x	39,451

Distribution of Depreciation

		Working	
	2002	2001	
Cost of			Land = 0
Goods Sold	1,602		Building = 15,818 - 10,775 = 5,040 x 10% = 504
Admin Expenses	2,387		Plant = 54,636 - 47,315 = 7,321 x 15% = 1,098
Selling Expenses	1,988		Furniture = 2,698 - 2,474 = 224 x 15% = 34
	5,977	x	Vehicles = 24,111 - 14,251 + 1,904 = 11,764 x 20% = 2,353
			Vehicles = 22,123 - 12,186 = 9,937 x 20% = 1,988

Note

2002
Rs'0002001
Rs'000Long Term Investment

Investment in Shares of Co. A	20,000	20,000
Investment in Shares of Co. B	2,500	2,500
Less: Prov. For Diminution in Value Co. B	1,875	1,250
	625	
	20,625	20,000

Long Term Deposits

Long Term Deposits	3,069	2,004
Less: Current Maturity	291	
	<u>2,778</u>	<u>2,004</u>

Stock in Trade

Raw Material	27,545	31,799
Packing Material	74,731	76,540
Finished Goods	78,550	80,300
	<u>180,826</u>	<u>188,639</u>

Trade Debtors

Trade Debts	18,185	25,307
Less: Provision for Doubtful Debts	1,210	323
	<u>16,975</u>	<u>24,984</u>

Advances Deposits and Prepayments

Advances	2,434	1,379
Deposits	816	1,730
Prepayments	1,637	1,305
Advance Excise Duty	2,601	2,192
Sales Tax Refundable	8,492	1,366
Other Receivables	375	394
Dividend Receivable	25,000	-
Accrued Profit on Bank Depreciation	388	460
Current Maturity of Long Term Dep.	291	-
	<u>42,034</u>	<u>8,366</u>

Cash and Bank

Cash in Hand	3,330	
Cash at Bank - Current Accounts	25,024	
Cash at Bank - Savings Accounts	16,521	
	<u>44,875</u>	

Creditors, Accrued & Other Liabilities

Creditors	63,016	58,997
Customers Deposits	22,571	19,866
Accrued Exp.	22,448	17,534
Other Liabilities	1,826	2,712
	<u>109,861</u>	<u>99,109</u>

Dividend Payable

Payable from Previous Year	200	164
Accrued During the Year	30,000	30,000
	<u>30,200</u>	<u>30,164</u>

Share Capital

Authorized Capital

10,000,000 (2000: 10,000,000)

ordinary shares of Rs. 10 each

100,000

100,000

Paid Up Capital

5,000,000 (2000: 5,000,000)

ordinary shares of Rs. 10 each

500,000

500,000

Obligation Under Lease Finance

Obligation. Under Lease Finance

15,282

10,585

Less: Current Maturity

6,643

3,425

8,639

7,160

Sales

Gross Sale - Domestic

751,244

Gross Sale - Export

93,305

Less: Sales Tax

106,158

738,391

Cost of Sales

Raw Material - Opening Stock

13,264

Raw Material - Purchases

291,569

Less : Raw Material - Closing Stock

27,545

Raw Material Consumed

277,288

Packing Material - Opening Stock

42,189

Packing Material - Purchases

190,295

Less: Packing Material - Closing Stock

74,731

Packing Material consumed

157,753

Overheads

Wages

23,155

Stores Consumed

7,922

Traveling and Conveyance.

158

Repairs and Maintenance.

10,267

Insurance

345

Fuel and Power

23,339

Bottle Breakage

6,552

Excise Duty

49,671

Misc. Expenses

7,412

Depreciation

3.1

1,602

130,423

Cost of Production

565,464

Finished Goods - Opening Stock	85,296
Less: Finished Goods - Closing Stock	<u>78,550</u>
Cost of Goods Sold	<u>572,210</u>

Other Income

Profit on Bank Deposits	974
Dividends Income	25,100
Foreign Exchange Gain	5,732
Gain on Disposal of F. Assts.	692
Sale of Scrap	<u>1,470</u>
	<u>33,968</u>

Administrative Expenses

Salaries and Wages		36,117
Postage and Telegram		1,652
Traveling and Conveyance		1,075
Repairs and Maintenance.		1,272
Insurance		1,179
Printing and Stationery		1,121
Rent, Rates and Taxes		1,155
Auditors' Remuneration		161
Legal and Professional		768
Donations		81
General Expenses		400
Depreciation	3.1	2,387
Provision for Doubtful Debts		987
Provision for Diminution in Value of Investment		<u>625</u>
		<u>48,980</u>

Selling and Distribution Expenses

Salaries and Wages		23,227
Postage and Telegram		1,578
Traveling and Conveyance		2,616
Repairs and Maintenance.		6,168
Vehicle Running		859
Printing and Stationery		497
Rent, Rates and Taxes		1,954
Advertising		19,254
Outward Freight		9,628
Sales Staff Incentives		1,642
Petrol, Oil etc.		8,561
Misc. Expenses		<u>1,392</u>

Depreciation	3.1	1,988
		79,364
<u>Financial Charges</u>		
Markup on Loans		282
Finance Lease Charges		1,750
Bank Charges		825
		2,857

Financial Ratio Analysis

The management of the business has to analyze several things to work out performance of the business. These analysis help the management in decision making. The management works out the performance of the business by calculating some ratios. Following are some of the important ratios, a management may calculate to get first hand knowledge about business's performance:

Profitability Ratios

Profitability ratios contain the following ratios:

- Gross Profit Ratio
- Net Profit Ratio

Gross Profit Ratio

The Gross Profit ratio tells the management of the company about profitability of the company. It helps the management of the company to know about cost of production of the company. When management compares it with previous year's ratios, it came to know, how well the business has performed and how to improve its efficiency further? Gross Profit ratio also gives information about sales. It tells the management whether sales has increased or decreased. The management takes appropriate steps accordingly. The formula for calculating this ratio is as follows:

$$\text{Gross Profit Ratio} = (\text{Gross Profit} / \text{Sales}) \times 100$$

Net Profit Ratio

The benefit of net profit ratio is same as that of gross profit ratio. It helps the management to know about net profit. If gross profit ratio is greater as compared to last year and net profit ratio is lesser, it means that administrative and selling expenses of the company have increased. The management takes appropriate steps to control the expenses. The formula for this ratio is as follows:

$$\text{Net Profit Ratio} = (\text{Net Profit} / \text{Sales}) \times 100$$

Stock Turnover Ratio

This ratio tells us about sale of stock. It can be calculated in days as well as in number of times. It tells us how many times in a year or in a month, the stock is sold or in how many days, the stock is sold. If it is calculated in days and the result is higher than that of previous years. This means that the stock takes more days to be sold. That means demand of the product of the company is decreasing and vice versa. The formula to calculate stock turnover in number of days is as follows:

$$\text{Stock Turnover in days} = (\text{Average Stock} / \text{Cost of goods sold}) \times 365$$

Where,

$$\text{Average stock} = (\text{Opening Stock} + \text{Closing Stock}) / 2$$

This opening and closing stock may be for a year or for a month depending upon the policy for calculating this ratio.

If this ratio is calculated for number of times, it means that how many times in a given period (whether a year or a month) the stock is sold. The formula for calculating this ratio is as follows:

$$\text{Stock Turnover (Number of times)} = (\text{Cost of goods sold} / \text{Average stock})$$

Debtors Turnover Ratio

This ratio is used to get first hand knowledge about payment received from debtors. It is evident that a company cannot meet its expenses without receiving cash from its customers. If debtors do not pay in time, how would a company pay its liabilities? Consequently its reputation will go down and nobody will place his trust on that company. This ratio helps management to identify debtors who do not pay in time and to pursue them to pay. This ratio is also calculated for number of days and number of times. The formulae for this ratio are as follows:

$$\text{Debtor Turnover (Number of days)} = (\text{Average Debtors} / \text{Credit Sales}) \times 365$$

$$\text{Debtor Turnover (Number of times)} = \text{Credit Sales} / \text{Average Debtors}$$

Creditors Turnover Ratio

Creditors' turnover means how many times or in how many days a company pays to its creditors. As mentioned above, if a company does not collect its payment in time, how would it be able to pay its creditors on time? If it does not pay its debtors on time, this situation will make bad impression on its reputation. Like debtors turnover, creditors' turnover is also calculated for number of days and number of times. The formulae for this ratio are as follows:

$$\text{Creditor Turnover (Number of days)} = (\text{Average Creditors} / \text{Credit Purchases}) \times 365$$

$$\text{Creditor Turnover (Number of times)} = \text{Credit Purchases} / \text{Average Creditors}$$

Return on Capital Employed Ratio (ROCE)

This ratio is calculated for the share holders of the company. As share holders are concerned with profit paid by companies to its share holders. This ratio gives us the proportion of net profit before tax to average capital employed by the company. The return rate of profit given to its members should be higher than current market rate. If return rate is less than current market rate than the share holders will invest their money in the market instead of investing in the company. The formula for calculating this ratio is as follows:

$$\text{Return on Capital Employed Ratio (ROCE)} = \text{Net profit after tax before appropriation} / \text{Average Capital Employed}$$

Earning Per Share Ratio

Earning per share ratio indicates the proportion of net profit; a company is getting per share. Share holders are always interested to know the proportionate rate; a company is getting per share. As price is numerator and earning in denominator, therefore lower value means better return.

The formula for calculating this ratio is as follows:

$$\text{Earning per share ratio} = \text{Net profit after tax before appropriation} / \text{Number of shares}$$

Price Earning Ratio

This ratio is calculated for those shares which have market value. This ratio compares earning per share with market value of that share. The formula for calculating this ratio is as follows:

$$\text{Price Earning Ratio} = \text{Market value per share} / \text{Earning per share}$$

Debt Equity Ratio

This ratio shows the composition of finance that has funded the asset of the company. This ratio varies for different projects. In Pakistan, maximum advised ratio is 60: 40. i.e. 40% of the assets should be bought with company, s investment and 60% should be bought with the loan taken by the company. This standard is acceptable in Pakistan. If a company's liquidity ratio is more than the above mentioned standard, which means condition of the company is not very good. If it has to pat its liabilities, its assets would not support it to pay its liabilities. The formula for calculating this ratio is as follows:

$$\text{Debt Equity Ratio} = \text{Long term Liabilities} / \text{Equity}$$

Current Ratio

Current ratio shows the proportion of current assets and current liabilities. This ratio should be 1:1. i.e.. For every liability of one rupee, there should be an asset of one rupee to pay it. The formula for calculating this ratio is as follows:

$$\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$$

Acid Test Ratio

Acid test ratio is the proportion of current assets which are convertible into cash and current liabilities. The formula for calculating this ratio is as follows:

$$\text{Acid Test Ratio} = (\text{Current Assets} - \text{Stock}) / \text{Current Liabilities}$$

Mark Up Cover Ratio

This ratio shows the proportion of operating profit (Operating Profit before financial charges) and financial charges. This ratio is useful for bankers. If a company has taken loan and its financial charges are so large that all or a big part of profit is absorbed by financial charges, then how would a company repay its loans. The formula for calculating this ratio is as follows:

$$\text{Mark up Cover Ratio} = \text{Operating Profit before financial charges} / \text{Financial charges}$$

-----THE END-----