

# **BALAJI INSTITUTE OF I.T AND MANAGEMENT KADAPA**

FINANCIAL ACCOUNTING FOR  
MANAGERS (17E00104)

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Units covered: **1<sup>st</sup> , 2<sup>nd</sup> & half of 3<sup>rd</sup> Units**

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**(17E00104) FINANCIAL ACCOUNTING FOR MANAGERS**

The Objective of the course is to provide the basic knowledge of book keeping and accounting and enable the students to understand the Financial Statements and make analysis financial accounts of a company.

**\* Standard discounting and statistical tables to be allowed in the examinations.**

- 1. Introduction to Accounting:** Definition, Importance, Objectives, uses of accounting and book keeping Vs Accounting, Single entry, and Double-entry systems, classification of accounts – rules of debit & credit.
- 2. The Accounting Process:** Overview, Books of Original Record; Journal and Subsidiary books, ledger, Trial Balance, Final accounts: Trading accounts- Profit & loss accounts- Balance sheets with adjustments, accounting principles.
- 3. Valuation of Assets:** Introduction to Depreciation - Methods (Simple problems from Straight line method, Diminishing balance method and Annuity method). Inventory Valuation: Methods of inventory valuation (Simple problems from LIFO, FIFO, Valuation of goodwill - Methods of valuation of goodwill.
- 4. Financial Analysis -I** Analysis and interpretation of financial statements from investor and company point of view, Liquidity, leverage, solvency and profitability ratios – Du Pont Chart -A Case study on Ratio Analysis
- 5. Financial Analysis-II:** Objectives of fund flow statement - Steps in preparation of fund flow statement, Objectives of Cash flow statement- Preparation of Cash flow statement - Funds flow statement Vs Cash flow statement.

**Textbooks:**

- Financial Accounting, Dr.S.N. Maheshwari and Dr.S.K. Maheshwari, Vikas Publishing House Pvt. Ltd.,
- Accountancy .M P Gupta & Agarwal ,S.Chand

**References:**

- Financial Accounting, P.C.Tulisan, S.Chand
- Financial Accounting for Business Managers, Asish K. Bhattacharyya, PHI
- Financial Accounting Management An Analytical Perspective, Ambrish Gupta, Pearson Education
- Accounting and Financial Management, Thukaram Rao, New Age International.
- Financial Accounting Reporting & Analysis, Stice & Stice, Thomson
- Accounting for Management, Vijaya Kumar, TMH
- Accounting for Managers, Made Gowda, Himalaya
- Accounting for Management, N.P.Srinivasan, & M.Shakthivel Murugan, S.Chand

# UNIT-1

## INTRODUCTION TO ACCOUNTING

### 1.1. Meaning of Account:

- Purchase or sale of goods on credit.
- Receipt or payment of money.
- Receipt or payment of money on account of previous dues.

**DEFINITION OF ACCOUNTING:** “The American Institute of Certified Public Accountants has defined “Accounting is a recording classifying summarizing& reporting to the business transaction”.

“Accounting is a means of measuring and reporting the results of economic activities”

- **Smith and Ashburne** –

“Accounting systems is a means of collecting, summarizing, analyzing and reporting in monetary terms, the information about the business”.

- **R.N.Anthony** –

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

- **American Institute of Certified Public Accountants (AICPA)** –

**Accounting:** American Institute of Certified Public Accountant (AICPA)

Accounting is the art of recording business transactions classify and summarizing in a significant manner and in terms of money transactions and events within part at least of a financial and interpreting the results thereof.

Ex:

1. B has paid Rs.1,00,000/- to X
2. N has paid Rs. 25,000/- to Business
3. Puneth today is leave
4. A has received Rs.1000

**Meaning of accounting:** Accounting is the language of business.

*“The art of recording, classifying and summarizing in a significant manner in terms of money transactions”.*

The main aim of a business is to earn a profit. For earning profit, the businessman will either purchase the goods in one market at certain price and sell it in another market at higher price or will convert the raw materials into finished products and sell it to the different customers at a price which will give him some percentage of profit on cost of production. But this may not be true in all cases.

### **1.1.1 History of Accounting:**

- Accounting is as old as civilization itself. From the ancient relics of Babylon, it can be well proved that accounting did exist as long as 2600 B.C.
- However, in modern form accounting based on the principles of Double Entry System, which came into existence in the 15<sup>th</sup> century.
- Fra Luka Paciolo, a mathematician published a book De competence scriptures in 1494 at Venice in Italy. This book was translated into English in 1543. In this book he covered a brief section on ‘book-keeping’.
- Paciolo used the terms ‘debito’ and ‘credito’ these words came from latic words debeo and credo. The terms debit and credit used today have its origin from debito and credito.

### **1.1.2 Origin of Accounting in India:**

- Accounting was practiced in India a thousand years ago and there is clear evidence for this. In his famous book *Arthashastra* ‘Kautilya’ dealt with not only politics and economics but also the art of proper keeping of accounts.
- However, the accounting on modern lines was introduced in India after 1850 with the formation of joint-stock companies in India.
- Accounting in India is now a fast developing discipline.
- The two premier accounting institutes in India viz., chartered Accountants o India and the Institute of Cost and Works Accountants of India are making continuous and substantial contributions.

## 1.2. IMPORTANCE OF ACCOUNTING:

- i) **Replacement of Human Memory:** as human memory is limited and short, it is difficult to remember all the transactions of the business. Therefore, all the financial transactions of the business are recorded in the books. In this way, the businessmen cannot only see the records at the required time but can also remember them for a long time. Thus, recording of the transactions is the replacement of human's memory.
- ii) **Helpful In The Determination Of Financial Results And Presentation Of Financial Position:** accounting is very useful in the determination of the profit and loss of business and showing the financial position of the business.
- iii) **Helpful in assessing the tax liability:** generally, a businessman has to pay corporate tax, VAT and excise duty, etc. therefore, it is necessary that proper accounts should be maintained to compute the tax liability of the business.
- iv) **Helpful in the case of insolvency:** sometimes the businessman becomes insolvent. If he has properly maintained the accounts, he will not face the problems in explaining few things in the court.
- v) **Helpful in the valuation of business:** if the business is shut down and sold, accounting helps the businessman to determine the value of the business. It would be possible only in that case when the accounts of the business are properly maintained.
- vi) **Helpful in the valuation of goodwill and shares:** if accounts of the business are properly maintained, it would be quite convenient to determine the value of goodwill. Goodwill is very important for the determination of the value of shares of the company.
- vii) **Accounting makes comparative statement possible:** proper and adequate accounting helps in comparing the income, expenditure, purchase, sale of the current year with that of the previous years. And then future plans, policies, and forecasting may be possible.
- viii) **It helps to make inter period and inter-firm comparison.** Accounting information recorded properly can be used to compare the results of one year with those of previous years and with those of their other enterprises.

ix) **It is an aid to the management.:** The information recorded properly can be used for meaning full analysis, so as to assist the management in decision making.

x) **It is needed for legal reasons:** Accounting information as recorded can be produced as a firm, evidence in a court of law. It helps in taxation matters and finalizing other contract details, etc.

### **1.3. OBJECTIVES OF ACCOUNTING:**

**1. Designing Work:** It includes the designing of the accounting system, basis for identification and classification of financial transactions and events, forms, methods, procedures, etc.,

**2. To maintain records of business:** One of the important objectives of accounting is the systematic maintenance of all monetary aspects of business transactions. This is known as book-keeping.

**3. To calculate Profit or Loss:** The profit earned or the loss suffered during a specific period can be calculated easily from the accounting books.

**4. To ascertain financial position:** By preparing the financial statements profit and loss account and balance sheet, the financial position of the business can be found out. From these statements it is possible to know the resources owned by the firm. These statements also provide information about the obligations of the business. Thus accounting aims at depicting the true and fair financial position of a concern.

**5. TO communicate financial information:** Accounting is called the language of business. It aims at communicating financial information to various interested parties.

**6. Preparation of Budget:** The management must be able to reasonably estimate future requirements and opportunities. As an aid to this process, the accountant has to prepare budgets, like cash budget, capital budget, purchases budget, sales budget, etc. this is known as 'Budgeting'.

**7. Taxation work:** The accountant has to prepare various statements and returns pertaining to income-tax, sales-tax, excise or customs duties, etc., and file that returns with the authorities concerned.

**8. Auditing:** It involves a critical review and verification of the books of accounts statements and reports with a view to verifying their accuracy. This is 'Auditing'.



## **1.4. USE, NATURE, FUNCTIONS, AND SCOP OF ACCOUNTING**

**1) Recording:** This is the basic function of accounting. It is essentially concerned not only with ensuring that all business transactions of financial character are recorded, but also that they are recorded in an orderly manner. The recording is done in the book “journal”. This may be further subdivided into various subsidiary books such as cash journal, purchases journal, sales journal, etc. the number of subsidiary books to be maintained will be according to the nature and size of the business.

**2) Classifying:** classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature in one place. The work of classification is done in the book termed as “Ledger”. This book contains on different pages, individual account heads under which, all financial transactions of similar nature are collected. For example, there may be separate account heads for traveling expenses, printing, and stationery, advertising, etc. all expenses under these heads, after being recorded in the journal, will be classified under separate heads in the ledger. This will help in finding out the total expenditure incurred under each of the above heads.

**3) Summarizing:** this involves presenting the classified data in a manner that is understandable and useful to the internal as well as external end-users of accounting statements. This process leads to the preparation of the following statements:

- i) trial balance
- ii) income statement and
- iii) balance sheet

**4) Dealing with financial transactions:** accounting records only those transactions and events in terms of money which are of a financial character. other transactions are not recorded in the books of account. For example, if a company has a team of dedicated and trusted employees, it is of great use to the business; but since it is not of a financial character and not capable of being expressed in terms of money, it will not be recorded in the books of business.

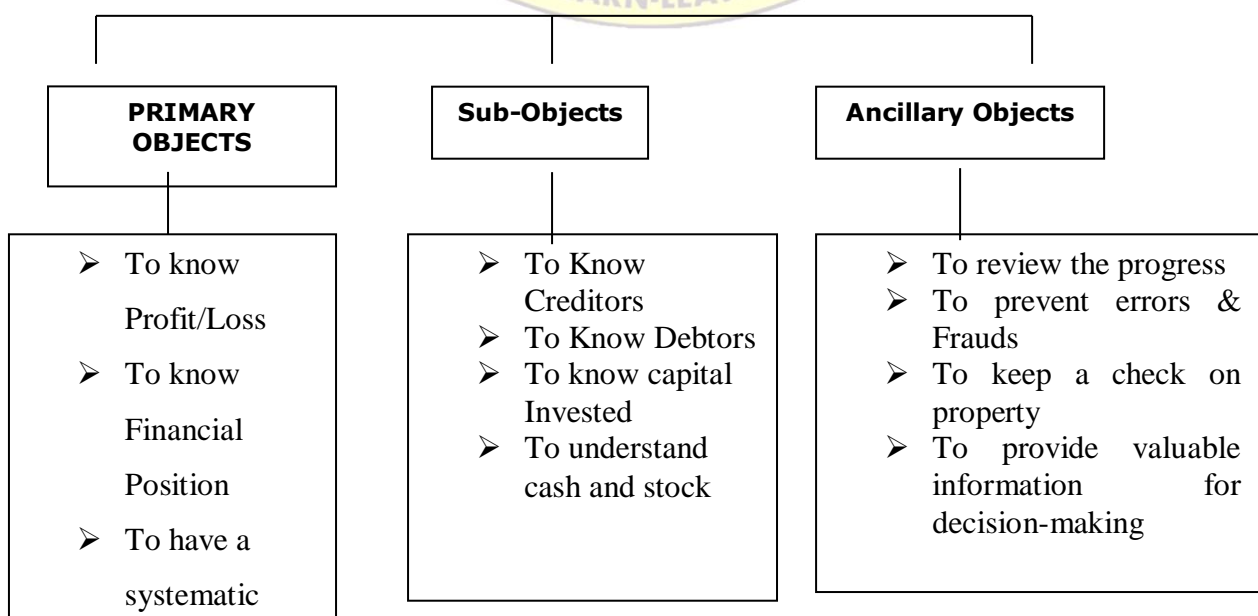
**5) Analyzing and interpreting:** this is the final function of accounting. The recorded financial data is analyzed and interpreted in a manner that will enable the end-users to make a meaningful judgment about the financial condition and profitability of the business operations. The data is also used for preparing future plans and framing the policies for executing such plans.

**6) Communicating:** the accounting information after being meaningfully analyzed and interpreted has to be communicated in a proper form and manner, to the proper person. This is done through the preparation and distribution of accounting reports, which include – besides the usual income statement and the balance sheet economists the marginal cost refers to the cost of producing one additional unit. Such cost per unit may increase or decrease depending upon the law of returns. For example in the case of law of increasing returns, the cost per unit .

### **1.5 BOOK-KEEPING Vs ACCOUNTING**

Sl.No	Points of Difference	Book-Keeping	Accounting
1	Object	The Object of Book-Keeping is to prepare original books of Accounts.	The main object of accounting is to record, analyze and interpret the business transactions.
2	level of work	Book-Keeping is restricted to the level of work. Clerical work is mainly involved in it.	Accountancy, on the other hand, is concerned with all levels of management
3	Principles of Accountancy	All without any difference.	On the other hand, various firms follow various methods of reporting and interpretation in accounting.
4	Final Result	In Book-Keeping it is not possible to know the final result of business every year.	Accounting gives the net results of the business every year.

### **5.1 Objects of book-keeping at a glance**





## **1.6. SINGLE ENTRY SYSTEM**

- A single entry system is an incomplete form of recording financial transactions.
- It is the system, which does not record two aspects or accounts of all the financial transactions.
- It is the system, which has no fixed set of rules to record the financial transactions of the business. A single entry system records only one aspect of transaction.
- Thus, a single entry system is not a proper system of recording financial transactions, which fails to present complete information required by the management.
- The single entry system mainly maintains cash books and personal accounts of debtors and creditors.
- Single entry system ignores nominal account and real account except cash account.
- Hence, it is an incomplete form of the double-entry system, which fails to disclose true profit or loss and financial position of a business organization.

### **1.6.1 Features of single entry system**

- 1. No Fixed Rules:** Single entry system is not guided by a fixed set of accounting rules for determining the amount of profit and preparing the financial statements.
- 2. Incomplete System:** Single entry system is an incomplete system of accounting, which does not record all the aspects of financial transactions of the business.
- 3. Cash Book:** Single entry system maintains a cash book for recording cash receipts and payments of the business organization during a given period of time.
- 4. Personal Account:** Single entry system maintains personal accounts of all the debtors and creditors for determining the number of credit sales and credit purchases during a given period of time.
- 5. Variations in Application:** Single entry system has no fixed set of principles for recording financial transactions and preparing different financial statements. Hence, it has variations in its application from one business to another.

### **Single Entry vs. Double Entry Accounting**

The single entry approach contrasts with double-entry accounting, in which every financial event brings at least two equal and offsetting entries. One is a debit (DR) and the other a credit (CR). As a result:

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

## **1.7. DOUBLE ENTRY SYSTEM**

- Every transaction as two aspects when you received something we give something else in writing. “Rule Double entry system. Purchase goods for cash. “Every debt they must be a corresponding credit”.
- In this business transaction we receive goods and give cash in return similarly when we sell goods on credit goods are given another customer becomes debtors this method of writing may transaction divided into two types debt and credit.
- One account is to be debt and another account is credit for every transaction in order to have a complete record of the same.
- Every transaction affects two accounts in opposite direction a transaction is to be recorded in two different accounts in opposite side for annual value both the accounts cannot be debited and another account is to be credit the basic principle of double-entry systems is to every debt they must be corresponding credit of equal value.
- The double-entry system is a scientific way of presenting accounts. As such all the business concerns feel it convenient to prepare the accounts under the double-entry system. The taxation authorities also compel the businessmen to prepare the accounts under the double-entry system.
- Under the dual aspect concept, the Accountant deals with the two aspects of business transactions. i.e.
  1. Receiving aspect (Debit Aspect)
  2. Giving aspect (Credit Aspect)

In the double-entry system book-keeping system these two aspects are recorded facilitating the preparation of trial balance and the final accounts therefrom.

### **1.7.1 Principle of double entry system**

- The systematically way of presenting the accounts is duly under the double-entry system. The single entry system is in fact not a system at all. It is nothing but an incomplete form of double-entry.

- Every business transaction has got two accounts, where one account is debited and another account is credited.
- If own account receives a benefit, there should be another account to part the benefit.
- The principle of double-entry is based on the fact that there can be no giving without receiving nor can there be receiving without something giving.

### **1.7.2 Advantages double-entry system:**

**1.Scientific System:** Double entry system records, classifies and summarizes business transactions in a systematic manner and, thus, produces useful information for decision-makers.

**2.Full Information:** Full and authentic information can be had about all transactions as the trader maintains the ledger with all types of accounts.

**3.Assessment of Profit and Loss:** The businessman/trader will be able to know correctly whether he had earned profit or sustained loss. It facilitates the trade to take such steps so as to increase the efficiency of the firm.

**4.Knowledge of debtors:** The trader will be able to know exactly what amounts are owed by different customers to the firm. If any amount is pending for a long time from any customer, he may stop credit facility to that customer.

**5.Knowledge of Creditors:** The trader also knows the exact amounts owed by the firm to others and he will be able to arrange prompt payment to obtain a cash discount.

**6.Arithmetical accuracy:** The arithmetical accuracy of the books can be proved by preparing a trial balance.

**7.Assessment of Financial Position:** The trader will be able to prepare the balance sheet which will help the interested parties to know fully about the financial position of the firm.

**8.Comparison of results:** It facilitates the comparison of the current year's results with previous years.

**9.Maintenance according to Income Tax Rules:** Proper maintenance of books will satisfy the tax authorities and facilitates accurate assessment. In India, joint-stock companies should maintain accounts under the double-entry system.

**10. Detection of frauds:** The systematic and scientific recording of business transactions on the basis of this system minimizes the chances of embezzlement and fraud. The frauds or errors can be easily detected by vouching. Verification and auditing of accounts.

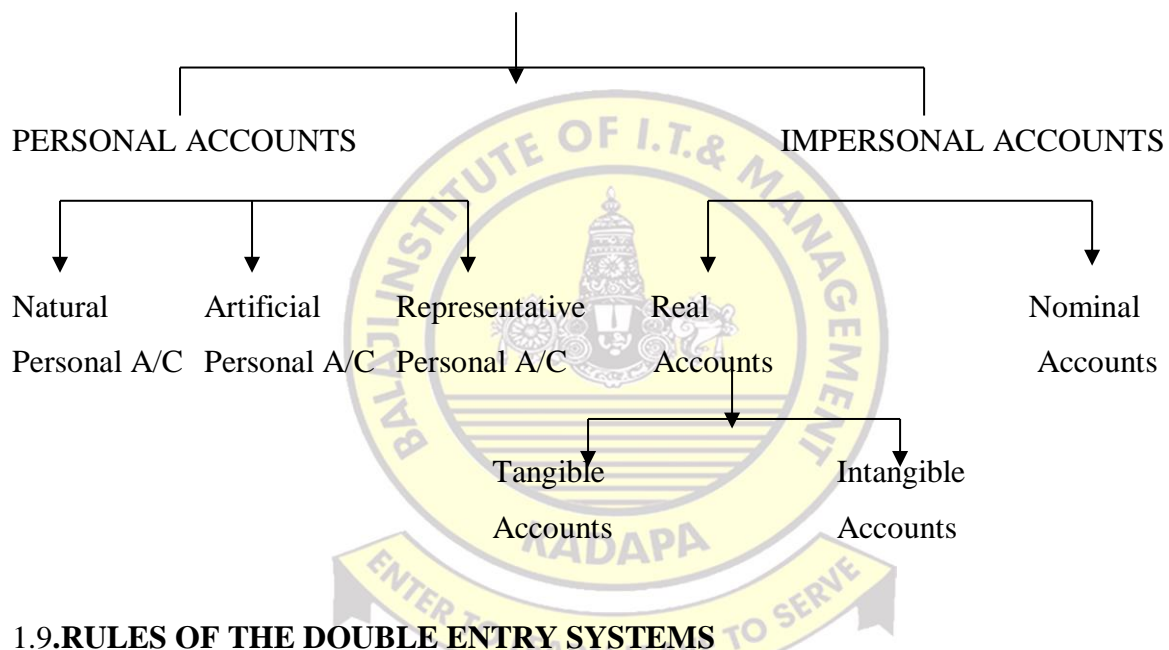
### **1.7.3 Disadvantage double entry systems:**

**1.Errors of Omission:** In case the entire transaction is not recorded in the double of accounts the mistake cannot be detected by accounting. The Trial Balance will tally in spite of the mistakes.

**2.Errors o principle:** Double entry is based upon the fact that every debit has to corresponding credit. It will not be able to detect the mistake such as debiting Ram's account instead of Rao's account or building an account in place of repairs account.

**3.Compensating errors:** If Rahim's account is by mistake debited with Rs.15 lesser and Mohan's account is also by mistake credited with Rs.15 lesser, the Trail balance will tally but the mistake will remain in accounts.

### **1.8. CLASSIFICATIONS OF ACCOUNTS (OR) TYPES OF ACCOUNTS**



### **1.9. RULES OF THE DOUBLE ENTRY SYSTEMS**

**I. personal accounts:** these accounts record a business's dealings with persons or firms. The person receiving something is given debited and the person giving something is given credit.

**a) Natural Personal A/C:** An account recording transactions with and individual human being is known as natural personal accounts.

**Ex:** Ramu A/C, Sindhu A/C, Nagendra A/C.

**b)Artificial Personal A/C:** An account recording financial transactions with an artificial person created by the law is called as artificial personal accounts.

**Ex:** SBI Bank A/C, Satyam InfoTech Ltd A/C

**c)Representative personal A/C:** An account indirectly representing a person or group of persons is known as representative personal A/C.

**Ex:** Salaries outstanding A/C, Interest outstanding A/C

**Rule:** Debit the Receiver, Credit the giver

**II. Real Accounts:** Real accounts means the business transactions deal with assets. these are the accounts of assets, asset entering the business is given credit. Real accounts again classified into two types i.e.,

1. Tangible real A/C
2. Intangible Real A/C

**a) Tangible Real A/C:** It relates to an asset that can be touchable felt sun and measured.

**Ex:** machinery A/C, Cash A/C

**b) Intangible Real A/C:** It relates to an asset that can be touched physically but can be measured in valued.

**Ex:** Goodwill A/C, Patents A/C

Rule: **Debit what comes in                      Credit what goes out**

**III Nominal Accounts:** It means the business transaction deals with expenses, loss incomes, and gains. Accounts of expenses and losses are debited and accounts of incomes and gains are credited.

Rule: **Debit all expenses and losses, Credit all incomes and gains**

### **1.9.1 Advantages of accounting:**

- 1. Provides systematic records:** since all the financial transactions are recorded in the books, one need not rely on memory. Any information required is readily available from these records.
- 2. Facilitate the preparation of financial statements:** Profit and loss account and balance sheet can be easily prepared with the help of the information in the records. This enables the trader to know the net result of business operations during the accounting period and the financial position of the business at the end of the accounting period.
- 3. Provides control over assets:** Book-keeping provides information regarding cash in hand, cash at bank, stock of good, accounts receivables from various parties and the amounts invested in various other assets. As the trader knows the values of the assets he will have control over them.
- 4. Provides the required information:** Interested parties such as owners, lenders, creditors, etc., get necessary information of frequent intervals.



5. **Comparative study:** One can compare the present performance of the organization with that of its past. This enables the managers to draw useful conclusions and make proper decisions.
6. **Less scope for fraud or theft:** It is difficult to conceal fraud or theft etc., because of the balancing of the books of accounts periodically. As the work is divided among many persons, there will be a check and counter check.
7. **Tax matters:** Properly maintained bookkeeping records will help in the settlement of all tax matters with the tax authorities.
8. **Ascertaining the value of business:** The accounting records will help in ascertaining the correct value of the business. This helps in the event of sale or purchase of a business.
9. **Documentary evidence:** Accounting records can also be used as evidence in the court to substantiate the claim of the business. These records are based on a documentary proof. Every entry is supported by authentic vouchers. As such, courts accept these records as evidence.
10. **Helpful to management:** Accounting is useful to management in various ways. It enables the management to find the achievement of its performance. The weakness of the business can be identified and corrective measures can be applied to remove them with help of accounting.

#### **1.9.2 Limitations of accounting:**

1. **It does not record all events:** Only the transactions of a financial character will be recorded under bookkeeping. So it does not reveal a complete picture of the quality of human resources, location advantage, business contacts.
2. **Does not reflect current values:** The data available under book-keeping is historical in nature. So they do not reflect current values. For instance, we record the value of the stock at cost price or market price, whichever is less.
3. **Estimates based on Personal Judgment:** The estimates used for determining the values of various items may not be correct.
4. **Inadequate information on costs and profits:** Book-keeping only provides information about the overall profitability of the business. No information is given about the cost and profitability of different activities of products or divisions.

## ACCOUNTING EQUATION:

American accountants have derived the rules of debit and credit through accounting equation which is given below:

Assets = Equities

The equation is based on the principle that accounting deals with property and rights to property and the sum of the properties owned are equal to the sum of the rights to the properties. The properties owned by a business are called assets and the rights to properties are known as liabilities or equities of the business.

Equities may be divided into equities of creditors representing debts of the business known as liabilities and equity of the owner known as capital. Keeping in view the two types of equities the equation given above can be stated as below:

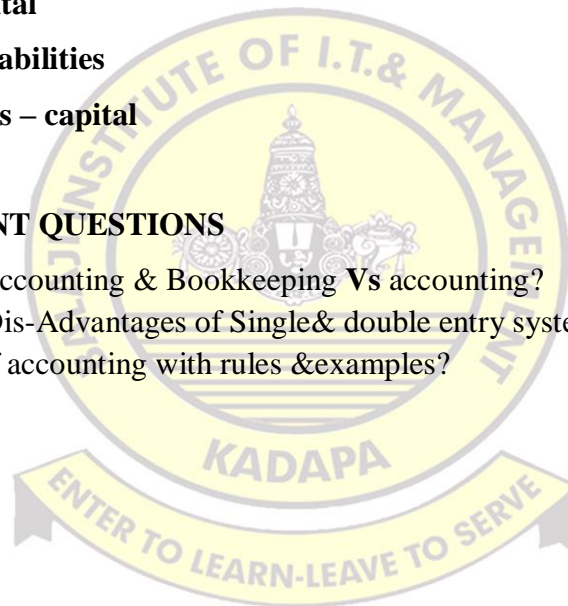
**Assets = liabilities capital**

**Or Capital = assets-liabilities**

**Or Liabilities = Assets – capital**

## UNIT-1 IMPORTANT QUESTIONS

- ✓ Importance, of accounting & Bookkeeping Vs accounting?
- ✓ Advantages & Dis-Advantages of Single& double entry system?
- ✓ Classification of accounting with rules &examples?



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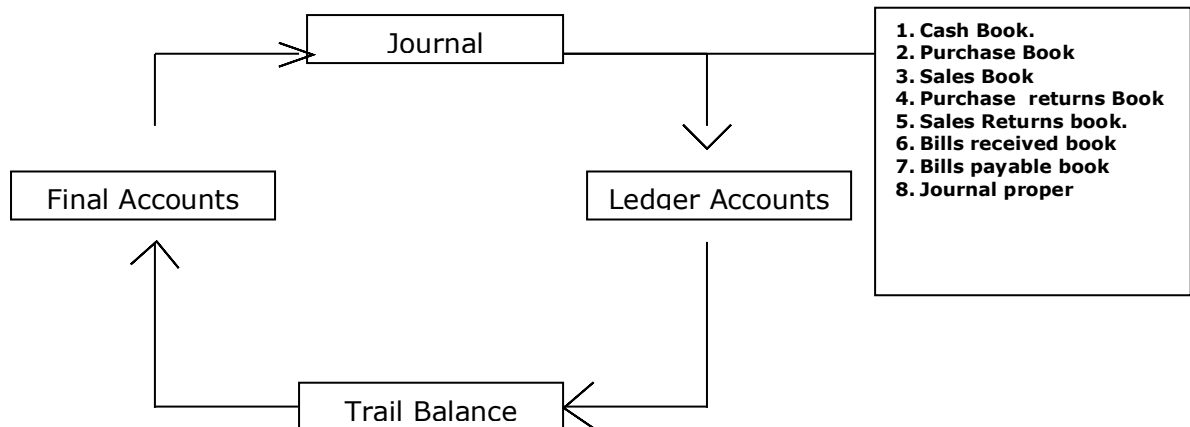
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- Accounting for Management, Vijaya Kumar, TMH
- Accounting for Managers, Made Gowda, Himalaya
- Accounting for Management, N.P.Srinivasan, & M.Shakthivel Murugan, S.Chand

## UNIT-2

### THE ACCOUNTING PROCESS



#### 2.1. ACCOUNTING OVERVIEW

- Every company needs the accounts department and accounting details of the company. An accounting department is the backbone of every business. It records all the business transactions and keeps a track of the incomes and expenses of the business. The business depends on these incomes for its profits and should know all the expenses that are incurred to keep it going. For the systematic and accurate recording of the transactions, accounting is important. Let us understand the accounting process in detail.

The accounting process can be defined as *"the process that begins when the transaction takes place and ends when the transaction is recorded in the books of accounts"*.

- The accounting process, also known as the accounting cycle process, includes the steps mentioned below. In order to follow these steps, you will need to know all the accounting principles and concepts well.
- The first step involves identifying the transaction and finding the source documents of the transaction.
- Analyze which account affecting and what is the amount of the transaction.
- Record the entry into the journal as a credit or debit, according to its nature.
- Transfer the journal entries into the appropriate accounts in the ledger.
- A trial balance is then created which sees to it that the debit amount equals the credit amounts.

- Prepare the final trial balance on the basis of the closing journal entries.
- Prepare financial statements( Trading and profit & loss account, Balance sheet)

## **2.2. BOOKS OF ORIGINAL RECORD**

**2.1 JOURNAL:** Journal is derived from the French word ‘jour’ which means a day. Journal, therefore, means a daily record of business transactions. Journal is a book of original entry because transaction is first written in the journal from which it is posted to the ledger at any convenient time. The ruling of the journal is as follows:

Journal

Date	Particulars	L.F.	Dr.Amount Rs.	Cr. Amount Rs.
Year Month Date	Name of account to be debited To Name of Account to be credited (Narration)  (A)            (B)			

**Column 1 (date):** the date of the transaction on which it takes place is written in this column. The year is written only in the first entry appearing on each page. This column is divided into two parts: the first part is used for writing the month and the second part is used for writing the date.

**Column2 \_ (particulars):** in this column, the name of the account to be debited is written first and is written close to the line marked (A). The word Dr. is written near the line marked (B). In the next line, the account to be credited is written preceded by the word “To” leaving a few spaces away from the (A). an explanation of the entry known as “narration” is also recorded in this column below the line giving credit to the account.

**Column 3 – (L.F.)** L.F. stands for ledger folio which means the page of the ledger. In this column are entered the page numbers on which the various accounts appear in the ledger.

**Column 4 \_ (Dr. Amount):** in this column, the amount to be debited against the ‘Dr’. The account is written along with nature of currency.

**Column 5\_ (Cr. Amount)** in this column the amount to be credited against the ‘Cr’. The account is written along with the nature of currency.



### **2.2.1.1 points to be noted before journalizing:**

**1. Capital account:** if the proprietor has introduced cash or goods or property in business, it is known as capital. It should be debited to the cash/stock of goods/property account and credited to the proprietor's capital account. It must be clearly understood that the entity of the proprietor is totally different from the business.

**2. Drawings account:** if the proprietor has withdrawn cash or goods from the business for his personal or domestic use, it is called drawings. It should be debited to the drawings account and credited to cash/ purchases account.

**3. Cash/credit transactions:** when goods are purchased or sold for cash, it is known as a cash transaction. If the goods are purchased or sold on credit i.e., the payment will be made or received after some time, it will be a credit transaction. If nothing is mentioned whether it is a credit or cash transaction, then it should be treated as a credit transaction. For example, goods sold to X for Rs.2,000 or goods purchased from Y for Rs. 1,000 etc.

**4. Casts and Carry forwards:** when journal entries extend to several pages of the journal, the totals are cast at the end of each page. At the end of each page the words ' Total C/f stands for carried forward are written in the particulars column against the debit and credit totals. On the next page, in the beginning the words Total b/f' is written in the particulars column against the debit and credit totals. At the end of a specified period or on the last page, the grand total is cast.

**5. Goods are given away as Charity:** if some goods from the business are given away as charity to a particular person or institution, it should be debited to charity account and credited to purchases account.

**6. Compound journal entry:** if there are two or more transactions of a similar nature occurring on the same day and either Dr. or Cr. Account is common, such transactions can be conveniently recorded in the form of one journal entry instead of making a separate entry for each transaction. Such entry is known as a compound journal entry.

**7. Opening entry:** the balances of the previous year are brought forward at the beginning of the year by means of an entry in a going concern. Such entry is made on the basis of accounting equation i.e., by debiting all assets and crediting liabilities and capital account.

**8. Cash Discount:** This discount is allowed by a creditor to a debtor when the latter pays the amount of goods purchased by him either immediately or within a specified period. It is an incentive given to a debtor for making an early payment. Thus if the seller allows 2% discount for payment within a month. On a bill of Rs. 20,000, the customer would pay Rs. 19,600 if the payment is made within a month otherwise he would have to pay Rs. 20,000 i.e., full amount of the bill. This discount is recorded in the books of accounts and a separate account is opened in the ledger. Being a nominal account discount allowed is debited and discount received credited. For examples:

i) **cash received from Mahesh Rs. 1900 and allowed him to discount Rs.100**

Cash A/c	Dr.	1,900	
Discount A/c	Dr.	100	
To Mahesh's A/c			2,000

ii) **Paid to Suresh Rs. 20,000 less 2% cash discount.**

Suresh A/c	Dr.	20,000	
To Cash A/c			19,600
To discount A/c			400
<b>(Cash paid and discount received)</b>			

**9. Trade discount:** it is a deduction on the gross value or list price of goods allowed by the manufacturer to the wholesaler or a wholesaler to a retailer in order to enable them to sell the goods further at list price to the consumer and yet earn a profit. Suppose, a manufacturer produced an article for Rs. 40 may fix Rs,100 as list price and allows 35% discount to the wholesaler. The wholesaler will thus get it at Rs.65 and may sell to the retailer at 20% trade discount. The retailer would thus get it for Rs. 80 and sell to the consumer at Rs. 100. Thus, the manufacturer earns a profit of Rs.25, the wholesaler Rs. 15 and the retailer Rs.20. it is deducted from the invoice or cash memo itself from the gross value of goods and is not recorded at all in the books of account. The journal entry will be passed with the net value of goods. For example, bought goods worth Rs.6,000 from Ram less 20% trade discount.

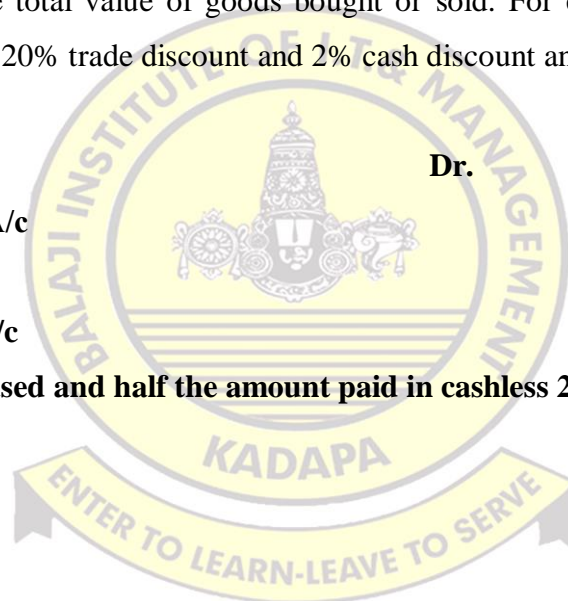
Purchases A/c	Dr.	4,800	
To Ram's A/c			4,800
<b>(For goods purchased from Ram)</b>			

Sometimes the purchaser may get the benefit of both discounts. In such a case, firstly trade discount is calculated on the gross value of goods sold and then the cash discount is calculated on the net value of goods. For example, bought goods worth Rs.6,000 from Ram less 29% trade discount and paid in cash full less 2% cash discount.

<b>Purchases Account</b>	<b>Dr.</b>	<b>4,800</b>
<b>To Cash</b>		<b>4,704</b>
<b>To Discount A/c</b>		<b>96</b>
<b>(For goods purchased for cash and discount received)</b>		

If the payment is made in part then the cash discount is calculated only on the amount paid and not on the total value of goods bought or sold. For example – Bought goods worth Rs.6,000 less 20% trade discount and 2% cash discount and paid half the amount in cash

<b>Purchases A/c</b>	<b>Dr.</b>	<b>4,800</b>
<b>To Supplier's A/c</b>		<b>2,400</b>
<b>To Cash A/c</b>		<b>2,352</b>
<b>To Discount A/c</b>		<b>48</b>
<b>( For goods purchased and half the amount paid in cashless 2% cash discount)</b>		





The following example will clear the accounting process from journalizing to posting transactions in the ledger.

**Example 13:** Journalize the following transactions and post them into ledger:

Date	Particulars
Aug. 1	Deposited ₹40,000 in the company's bank account in exchange for 4000 shares
2	Paid two months' office rent in advance ₹2,200
3	Bought testing equipment on credit ₹6,500
4	Bought office supplies for cash, ₹480
7	Received fees for services provided ₹6,900
13	Ordered testing equipment ₹3,200
16	Paid assistants' salaries for first fortnight ₹2,300
19	Billed customers for services provided ₹9,700
20	Received testing equipment ordered on August 15 and agreed to pay for it on September 5
28	Paid telephone bill for the month ₹390
29	Received cash for services to be provided later ₹2,700
30	Paid assistants' salaries for second fortnight, ₹2,300

You are required to prepare journal entries to record the transactions in the general journal and post entries in ledger on August 31<sup>st</sup>.

**Solution:**

**Journal Entries**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
August 1	Bank A/c To Share Capital A/c (Being deposited 40,000 in the company's bank account in exchange for 4,000 shares )	Dr.	40,000	40,000
August 2	Prepaid Office Rent A/c To Cash A/c (Being paid office rent in advance )	Dr.	2,200	2,200
August 3	Testing Equipment A/c To Creditors A/c (Being bought testing equipment on credit)	Dr.	6,500	6,500
August 4	Office Supplies A/c To Cash A/c (Being bought office supplies for cash)	Dr.	480	480
August 7	Cash A/c To Revenue from Services A/c (Being revenue received from providing services)	Dr.	6,900	6,900
August 16	Salaries A/c To Cash A/c (Being paid assistance salaries)	Dr.	2,300	2,300
August 19	Debtors A/c To Revenue from Service A/c (Billed customer for services provided)	Dr.	9,700	9,700
August 20	Testing Equipment A/c To Creditors A/c (Being received testing equipment which is ordered for 3,200)	Dr.	3,200	3,200
August 28	Telephone Expenses A/c To Cash A/c (Being paid telephone bill)	Dr.	390	390
August 29	Cash A/c To Advance from Customer A/c (Being cash received for providing later services)	Dr.	2,700	2,700
August 30	Salaries A/c To Cash A/c (Being salaries paid for second fortnight)	Dr.	2,300	2,300
	<b>Total</b>		<b>76,670</b>	<b>76,670</b>



Ledger							
Bank Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr. J.F. ₹
	August 1	To Share Capital A/c		40,000	August 31	By Balance c/d	40,000
				<b>40,000</b>			<b>40,000</b>
		To Balance b/d		40,000			
Share Capital Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr. J.F. ₹
	August 31	To Balance c/d		40,000	August 1	By Bank A/c	40,000
				<b>40,000</b>			<b>40,000</b>
						By Balance b/d	40,000
Advance Office Rent Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr. J.F. ₹
	August 2	To Cash A/c		2,200	August 31	By Balance c/d	2,200
				<b>2,200</b>			<b>2,200</b>
		To Balance b/d		2,200			
Cash Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr. J.F. ₹
	August 7	To Revenues from Services A/c		6,900	August 2	By Advance Office Rent A/c	2,200
	August 29	To Advance from Customer A/c		2,700	August 4	By Office Supplies A/c	480
					August 16	By Salaries A/c	2,300
					August 28	By Telephone Expenses A/c	390
					August 30	By Salaries A/c	2,300
					August 31	By Balance c/d	1,930
				<b>9,600</b>			<b>9,600</b>
		To Balance b/d		1,930			
Testing Equipment Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr. J.F. ₹
	August 3	To Creditors A/c		6,500	August 31	By Balance c/d	9,700
	August 20	To Creditors A/c		3,200			
				<b>9,700</b>			<b>9,700</b>
		To Balance b/d		9,700			
Creditors Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr. J.F. ₹
	August 31	To Balance c/d		9,700	August 3	By Testing Equipment A/c	6,500
					August 20	By Testing Equipment A/c	3,200
				<b>9,700</b>			<b>9,700</b>
						By Balance b/d	9,700
Office Supplies Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr. J.F. ₹
	August 4	To Cash A/c		480	August 31	By Balance c/d	480
				<b>480</b>			<b>480</b>
		To Balance b/d		480			
Revenue from Services Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr. J.F. ₹
	August 31	To Balance c/d		16,600	August 7	By Cash A/c	6,900
					August 19	By Debtors A/c	9,700
				<b>16,600</b>			<b>16,600</b>
						By balance b/d	16,600
Salaries Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr. J.F. ₹
	August 16	To Cash A/c		2,300	August 31	By Balance c/d	4,600
	August 30	To Cash A/c		2,300			
				<b>4,600</b>			<b>4,600</b>
		To Balance b/d		4,600			



Debtors Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr.
	August 19	To Revenue from Services A/c		9,700	August 31	By Balance c/d	9,700
				9,700			9,700
		To Balance b/d		9,700			

Telephone Expense Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr.
	August 28	To Cash A/c		390	August 31	By Balance b/d	390
				390			390
		To Balance b/d		390			

Advance from Customer Account							
Dr.	Date	Particulars	J.F.	₹	Date	Particulars	Cr.
	August 31	To Balance c/d		2,700	August 29	By Cash A/c	2,700
				2,700			2,700
						By balance b/d	2,700

### 2.1.2. Difference between Trade Discount and Cash Discount

The following are the main differences between a trade discount and cash discount.

Basis of Distinction	Trade Discount	Cash discount
1. When allowed	It is allowed on a certain quantity being purchased or as a trade practice.	It is allowed when payment is made before a certain date.
2. Purpose	It is given to promote sales.	It is allowed to encourage early cash payment.
3. Vary with	It may vary with the number of goods purchased.	It may vary with the period within which the payment is to be made.
4. Entry in books	It is not recorded in the books of account.	A separate account in the ledger is maintained for such a discount.
5. Deduction	It is deducted from the Invoice. It is offered at the time of sale or purchase.	It is not deducted from the invoice. It is offered at the time of getting a quick payment.
6. When offered	It is usually given in percentage.	It may be given in percentage or in the absolute figure.
7. Form	it is given on the list price or catalogue price or retail price.	

### 2.2.2 SUBSIDIARY BOOKS:

- Subsidiary Books are those books of original entry in which transactions of similar nature are recorded in one place and in chronological order.

- In a big concern, recording of all transactions in one Journal and posting them into various ledger accounts will be very difficult and involve a lot of clerical work.
- This is avoided by sub-dividing the journal into various subsidiary journals or books.
- The subdivisions of the journal into various subsidiary journals for recording transactions of similar nature are called as ‘Subsidiary Books.

### 2.2.2.1 TYPES OF SUBSIDIARY BOOKS

- 1. Purchases Day Book** – for recording credit purchase of goods only. Cash purchases or assets purchased on credit are not entered in this book.
- 2. Sales Day Book** – for recording credit sales of goods only. Assets sold or cash sales are not recorded in this book.
- 3. Purchases Returns Book** – for recording the goods returned to the suppliers when purchased on credit.
- 4. Sales Returns Books** – for recording goods returned by the customers when sold on credit.
- 5. Bills Receivable Book** – for recording the bills received [Bills Receivables] from customers for credit sales.
- 6. Bills Payables Book** – for recording the acceptances [Bills Payables] given to the suppliers for credit purchases.
- 7. Cash Book** – for all receipts and payments of cash.
- 8. Journal Proper** – for recording any transaction which could not be recorded in the above-mentioned subsidiary books. For example, assets purchased or sold on credit and opening entry, etc., are entered in this book.

Prepare proper subsidiary books from the following data.

Date	Particulars	₹
<b>2014</b>		
April 1	Purchased goods from Sakshi	12,000
April 5	Sold goods to Prakash	15,000
April 8	Bought goods from Shwetha	5,000
April 12	Returned goods to Sakshi	400
April 15	Goods returned to from Prakash	200
April 18	Goods returned to Shwetha	500
April 21	Purchased goods from Sakshi	20,000
April 25	Purchased goods from Shwetha	2,000
April 30	Sold goods to Prakash	5,000
April 30	Returned goods to Sakshi	2,000

**Purchase Book**

Date	Particulars	L.F.	Inward Invoice Number	₹
2014				
April 1	Sakshi			12,000
April 8	Shwetha			5,000
April 21	Sakshi			20,000
April 25	Shwetha			2,000
	<b>Total</b>			<b>39,000</b>

**Sales Book**

Date	Particulars	L.F.	Outward Invoice Number	₹
2014				
April 5	Prakash			15,000
April 30	Prakash			5,000
	<b>Total</b>			<b>20,000</b>

**Purchase Return Book**

Date	Particulars	L.F.	Debit Note	₹
2014				
April 12	Sakshi			400
April 18	Shwetha			500
April 30	Sakshi			2,000
	<b>Total</b>			<b>2,900</b>

**Sales Return Book**

Date	Particulars	L.F.	Credit Note	₹
2014				
April 15	Prakash			200
	<b>Total</b>			<b>200</b>



## Bills Receivable Book

Bills which are written by the trader but accepted by other party (customers) and returned to the trader after acceptance, are known as Bills Receivables and are recorded in a subsidiary book known as Bills Receivable Book/Journal. The rulings such book is as under:

### Proforma

The simplest proforma of Bills Receivable Book is shown below:

#### Bills Receivable Book

S. No.	Date of Receipt	From whom received	Drawer	Acceptor	Where Payable	Date of Bill	Term	Due date	L.F.	Amount	Remarks

## Bills Payable Book

The bills which have been drawn by other parties (suppliers) but accepted by the trader are called Bills Payable for the proprietor because he has to pay these bills on due dates. All such bills are recorded in a separate subsidiary book known as Bills Payable Book. The rulings of such book are as under:

### Proforma

The simplest format of Bills Payable Book is shown below:

#### Bills Payable Book

S. No.	Date of Bill	To whom given	Drawer	Payee	Where Payable	Term of Bill	Due Date	L.F.	Amount	Payment Date	C. B. Folio	Remarks

**Example 12:** Prepare Bills Receivable and Bills Payable Book from the following particulars:

Date	Particulars
2014	
April 5	Hamid accepted the bills for ₹8,000 payable after 3 months.
7	Bills payable accepted from Raja for ₹12,000 payable 2 months.
9	We accepted bills of Anuj for ₹10,000 payable 50 days.
17	Bill for ₹5,000 payable after 4 months accepted by Suraj.
27	Mukesh accepted our bill for ₹9,000 payable after 90 days received.

### Solution:

#### Bills Receivable Book

Date	From whom Received	Term	Due Date	L.F.	₹	Remarks
2014			2014			
April 5	Hamid	3 months			8,000	
17	Suraj	4 months			5,000	
27	Mukesh	90 days			9,000	

#### Bills Payable Book

Date	From whom Received	Term	Due Date	L.F.	₹	Remarks
2014						
April 7	Raja	2 months			12,000	
9	Anuj	50 days			10,000	

**Example 1:** Record the following transactions in Three-column cash book:

2014 Feb., 1 <sup>st</sup>	Commenced business with cash ₹10,000
Feb., 6 <sup>th</sup>	Received a cheque for ₹5,000 for goods sold
Feb., 7 <sup>th</sup>	Issued a cheque for ₹500 furniture purchased
Feb., 8 <sup>th</sup>	Purchased good for ₹3,000 and paid by cheque
Feb., 8 <sup>th</sup>	Received a cheque for ₹490 in settlement of ₹500 on account
Feb., 10 <sup>th</sup>	Paid into Bank of India ₹5,000 received from Rangan
Feb., 15 <sup>th</sup>	Paid wages in cash ₹200
Feb., 18 <sup>th</sup>	Drew a cheque for personal use ₹400
Feb., 25 <sup>th</sup>	Drew for office use ₹250
Feb., 27 <sup>th</sup>	Paid electricity charges in cash ₹15
Feb., 28 <sup>th</sup>	Paid salaries by cheque ₹1,000

**Solution:**

**Three Column Cash Book**

Dr.						Cr.					
Receipts						Payments					
Date	Particulars	L.F.	Discount (₹)	Cash (₹)	Bank (₹)	Date	Particulars	L.F.	Discount (₹)	Cash (₹)	Bank (₹)
2014						2014					
1 Feb	To Capital A/c			10,000		7 Feb	By Furniture A/c				500
6 Feb	To Sales A/c				5,000	8 Feb	By Purchase A/c				3,000
8 Feb	To Debtor A/c		10		490	15 Feb	By Wages A/c			200	
10 Feb	To Rangan A/c				5,000	18 Feb	By Drawing A/c				400
25 Feb	To Bank A/c	(C)*		250		25 Feb	By Cash A/c	(C)*			250
						27 Feb	By Electric Charges A/c			15	
						28 Feb	By Salary A/c				1,000
						29 Feb	By Balance c/d				
			10	10,250	10,490					10,035	5,340
1 <sup>st</sup> March	To balance b/d			10,035	5,340					10,250	10,490

### 2.2.3 LEDGER:

- As we know, the journal records all business transactions separately and date wise.
- The transactions pertaining to a particular person, asset, expense or income are recorded at different places in the journal as they occur on different dates.
- Thus, to have a consolidated view of the similar transactions different accounts are prepared in the ledger.
- A ledger account may be defined as a summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time and shows their net effect.



### **2.2.3.1 Advantages or merits:**

- It provides complete information about all accounts in one book.
- It is easy to ascertain how much money is due to suppliers (from creditor's ledgers) and how much money is one from customers (from debtors ledgers).
- It enables us to ascertain, what are the main items of revenue or incomes (nominal account).
- It enables to ascertain what are the expenses of the main items (nominal account)
- It enables to know the kind of assets the company holds and their respective values (real account)
- It facilitates the preparation of trial balance and thereafter preparation of financial statements i.e., P&L A/c and balance sheet.

### **2.2.3.2 Differences between Journal and Ledger:**

S.NO	Basis of difference	Journal	Leger
1.	Nature of Book	It is a book of original entry	It is a book of final entry.
2.	Object	It is prepared to record all the transactions in chronological order (date wise)	It is prepared to know the effect of various transactions affecting a particular account.
3.	Basis of Preparation	It is prepared on the basis of transactions.	It is prepared on the basis of the journal.
4.	Stage of recording	Recording in the journal is the first stage.	Recording in the ledger is the second stage.
5.	Balancing	Journal is not balanced	All ledger A/c are balanced.
6.	Narration	Narration is written for each entry.	No narration is given
7.	Format	In the journal, there are 5 columns viz, date, particulars, L.F. Dr and Cr.	In ledger there are 4 columns on debit and credit side viz. date, particulars, journal folio and amount.
8.	Name of the process	The process of recording in a journal is called journalizing.	The process of recording in the ledger is called ledger posting.
9.	Basis of preparation of Final A/c	Journal directly doesn't serve as the basis for preparation of final account.	Ledger serves the basis for the preparation of final accounts.

### **2.2.4 TRIAL BALANCE:**

- The agreement of the trial balance reveals that both the aspects of each transaction have been recorded and that the books are arithmetically accurate.
- If the trial balance does not agree, it shows that there are some errors that must be detected and rectified if the correct final accounts are to be prepared.
- Thus, trial balance forms a connecting link between the ledger accounts and the final accounts.

#### **2.2.4.1 Preparation of trial balance:**

1. Total method: in this method, the debit and credit totals of each account are shown in the two amount columns against it.
2. Balance method: in this method, the difference of each account is extracted. If the debit side of an account is bigger in amount than the credit side, the differences are put in the debit column of the trial balance and if the credit side is bigger, the difference is written in the credit columns of the trial balance.

Trial balance can be prepared on a loose sheet having four columns. A specimen is given as follows:

Trial balance of - - - - As on - - - -

Serial No.	Name of the account	Dr. Balance (or Total ) Rs.	Cr. Balance (or Total) Rs.

Of the two methods of preparation, the second is usually used in practice because it facilitates the preparation of the final accounts

A trial balance can be prepared by the following two methods:

1. Total method: in this method, the debit and credit totals of each account are shown in the two amount columns (one for the debit total and the other for the credit total) against it.
2. Balance method: in this method, the difference of each account is extracted. If the debit side of an account is bigger in amount than the credit side, the difference is put in the debit column of the trial balance and if the credit side is bigger, the difference is written in the credit column of the trial balance.

Of the two methods of preparation, the second is usually used in practice because it facilitates the preparation of the final accounts.

### 2.2.4.2 Specimen of trial balance

Particulars	Debit (Assets & Expenditure) Rs.	Credit (Liabilities & Incomes) Rs.
Capital		XXX
Purchases	XXX	
Purchase returns		XXX
Sales		XXX
Sales returns	XXX	
Carriage	XXX	
Wages	XXX	
<b>All expenses and losses</b>	XXX	
Direct and indirect expenses		
<b>All incomes and gains</b>		
<b>All assets</b>	XXX	
Current assets, fixed assets, intangible assets, and fictitious assets.		
<b>All liabilities</b>		XXX
Current liabilities, long-term liabilities etc.	XXX	
Discount allowed		XXX
Discount received	XXX	
Drawings	XXX	
Taxation paid	XXX	
Dividend paid	XXX	
Bad debts and reserves	XXX	
Suspense A/c		
	XXX	XXX

**Example** : A book-keeper drew-up the following Trial Balance for the year ended 31<sup>st</sup> December 2013:

Heads of Accounts	L.F.	Dr. (₹)	Cr. (₹)
Capital A/c		-	30,000
Drawings A/c		5,000	-
Purchases A/c		16,000	-
Sales A/c		-	45,000
Returns Inwards A/c		-	3,000
Returns Outwards A/c		2,000	-
Carriage Inwards A/c		1,000	-
Carriage Outwards A/c		-	2,000
Bank Overdraft A/c		6,000	-
Provision for Bad Debts A/c		3,000	-
Discount Allowed A/c		-	1,000
Discount Received A/c		2,000	-
General Expenses A/c		5,000	-
Plant and Machinery A/c		10,000	-
Sundry Debtors A/c		8,000	-
Sundry Creditors A/c		-	5,000
Opening Stock A/c		4,000	-
Cash in hand A/c		8,000	-
Dividend Received		-	4,000
Goodwill A/c		17,000	-
		<b>87,000</b>	<b>90,000</b>

**You are required to:**

Draw up a corrected Trial Balance after transferring the errors to Suspense Account.

**Solution:**

In the books of .....

**Trial Balance**

(as at 31<sup>st</sup> December 2013)

Heads of Accounts	L.F.	Dr. (₹)	Cr. (₹)
Capital A/c		-	30,000
Drawings A/c		5,000	-
Purchases A/c		16,000	-
Sales A/c		-	45,000
Returns Inwards A/c		3,000	-
Returns Outwards A/c		-	2,000
Carriage Inwards A/c		1,000	-
Carriage Outwards A/c		2,000	-
Bank Overdraft A/c		-	6,000
Provision for Bad Debts A/c		-	3,000
Discount Allowed A/c		1,000	-
Discount Received A/c		-	2,000
General Expenses A/c		5,000	-
Plant and Machinery A/c		10,000	-
Sundry Debtors A/c		8,000	-
Sundry Creditors A/c		-	5,000
Opening Stock A/c		4,000	-
Cash in hand A/c		8,000	-
Dividend Received A/c		-	4,000
Goodwill A/c		17,000	-
Suspense A/c		17,000	-
		<b>97,000</b>	<b>97,000</b>



**Example :** Prepare Trial balance from the following:

Capital ₹50,000; Sales ₹25,000; Opening stock 5,200; Debtors ₹2,500; Creditor ₹1,000; Purchases ₹20,000; Salaries ₹2,000; Rent ₹1,500; Cash ₹2,000; Insurance ₹300; Drawing ₹10,000; Plant ₹28,000, and Bank ₹4,500.

**Solution:**

Trial Balance			
Particulars	L.F.	Dr. (₹)	Cr. (₹)
Capital		-	50,000
Sales		-	25,000
Opening stock		5,200	-
Debtors		2,500	-
Creditors		-	1,000
Purchases		20,000	
Salaries		2,000	
Rent		1,500	
Cash		2,000	
Insurance		300	
Drawings		10,000	
Plant		28,000	
Bank		4,500	
<b>Total</b>		<b>76,000</b>	<b>76,000</b>

## 2.3.FINAL ACCOUNTS

- Two main objectives of maintaining accounts are to find out the profit or loss made by the business at the end of regular periodic intervals and to ascertain the financial position of the business on a given date.
- Final accounts are prepared to achieve the objectives of accountancy.
- In order to know the profit or loss earned by a firm, Income Statement or Trading and Profit and Loss account is prepared.
- Balance Sheet or Position Statement will portray the financial condition of the firm on a particular date. These two statements, i.e., Trading and Profit & Loss Account and Balance Sheet are prepared to give the final results of the business, that is why both these are collectively called as final accounts.

Thus, final accounts include the preparation of :

- I. Trading and Profit and Loss Account; and
- II. Balance Sheet.



### **2.3.1 TRADING ACCOUNT**

<b>Particulars</b>	<b>Amount Rs.</b>	<b>Particulars</b>	<b>Amount Rs.</b>
To Opening Stock To Purchases Less: Purchase Returns To Direct Expenses To Carriage Inward To Wages To Wage and Salaries To Fuel and Power To Manufacturing or Production Expenses. To Coal, Water, and Gas To Motive Power To Factory Lighting To Octroi To Import Duty To Custom Duty To Excise Duty To Consumable Stores To Foreman/Works Manager's Salary To Factory Rent, Rated and Taxes To Royalty on Manufactured Goods To Gross Profit C/d		By Sales Less: Sales Returns By Closing Balance By Gross Loss C/d	
	<b>XXXX</b>		<b>XXXX</b>

**2.3.2 PROFIT AND LOSS ACCOUNT:** This account is prepared to calculate the net profit of the business.

**The specimen of profit and loss A/c, For the year ended 31<sup>st</sup> March 2000**

<b>To Gross Loss b/d</b> <b>To Selling and Distribution</b> Expenses: Advertisement Travelers' Salaries, Expenses & Commission Bad Debts Carriage Outward Bank charges Agent's Commission Upkeep of Motor Lorries <b>To Management Expenses:</b> Rent, Rates, and Taxes Heating and Lighting office Salaries Printing & Stationery Postage & Telegrams Telephone Charges Legal Charges Audit Fees Insurance General Expenses <b>To Depreciation and</b> Maintenance: Depreciation Repairs & Maintenance <b>Financial Expenses:</b> Discount Allowed Interest on Capital Interest on Loans Discount on Bills Discounted <b>To Extraordinary Expenses:</b> Loss by fire (not covered by Insurance) Cash Defalcations <b>To Net Profit transferred to</b> <b>Capital A/c*</b>	Rs.	<b>By Gross Profit b/c</b> By Interest Received By Discount Received By Commission Received By Rent From Tenants Received By Income from Investments By Apprenticeship Premium By Interest on Debentures By Income from any other Source By Miscellaneous Revenue Receipts By Net Loss transferred to Capital A/c*	

\* **Balancing figure will be either net profit or a net loss.**

### **2.3.3 BALANCE SHEET**

- A balance sheet is a statement prepared with a view to measure the financial position of a business on a certain fixed date.
- The financial position of concern is indicated by its assets on a given date and its liabilities and that date.
- Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company; a balance sheet is also described as a 'statement showing the sources and application of capital'.
- It is a statement and not an account and prepared from real and personal accounts.
- The left-hand side of the balance sheet may be viewed as a description of the sources from which the business has obtained the capital with which it currently operates and the right-hand side as a description of the form in which that capital is invested on a specified date.
- On the left-hand side of the balance sheet, the several liability items described how much capital was obtained from trade creditors, from banks, from bill holders and other outside parties. The owner's equity section shows the capital supplied by the owner.

#### **Grouping and Marshalling of Assets and Liabilities:**

<i>Liabilities</i>	<i>Amount Rs.</i>	<i>Assets</i>	<i>Amount Rs.</i>
<b>Current Liabilities:</b> Bills Payable Sundry Creditors Bank Overdraft <b>Long Term Liabilities:</b> Loan from Bank Loan from Wife <b>Fixed Liabilities:</b> Capital		<b>Liquid Assets:</b> Cash in Hand Cash at Bank <b>Floating Assets:</b> Sundry Debtors Investments Bills Receivable Stock in Trade Prepaid Expenses <b>Fixed Assets:</b> Machinery Building Furniture & Fixtures Motor Car <b>Intangible Assets:</b> Goodwill Patents Copyright Licenses <b>Fictitious Assets:</b> Advertisement Misc. Expenses (to the extent not written off) Profit & Loss A/c	

### **2.3.4 Treatment of items appearing in the trial balance:**

<b>Items</b>	<b>Profit &amp; loss account</b>	<b>Balance sheet</b>
1. closing stock	_____	Shown in the asset side of balance sheet.
2. outstanding expenses or accrued expenses	_____	Shown in the liability side of the balance sheet.
3. prepaid expenses	_____	Shown in the asset side of the balance sheet
4. Accrued income	_____	Shown in the asset side of the balance sheet.
5. unearned income	_____	Shown in the liability side of the balance sheet.
6. Depreciation	Shown in the Dr side of Profit & Loss account	_____
7. Interest on capital	Shown in the Dr side of Profit & Loss account	_____
8. drawings	_____	Less from the capital on the balance sheet liabilities side



**Example :** From the following balances extracted from the books of R and Co. prepare Trading and Profit and Loss account and Balance sheet.

Particulars	₹	Particulars	₹
Opening Stock	1,250	Plant and Machinery	6,230
Sales	11,800	Purchase Returns	1,380
Depreciation	700	Cash	1,195
Commission received	200	Salaries Paid	750
Insurance Premium	380	Debtors	2,905
Carriage Inwards	300	Discount Paid	300
Furniture	2,670	Bills receivables	3,250
Printing and Stationery	481	Wages	1,589
Carriage Outwards	200	Sales Returns	1,659
Capital	9,004	Bank Overdraft	6,000
Creditors	3,300	Purchases	8,679
Bills payable	1,084	Petty cash	50
Bad Debts	180		

Value of the stock as on 31st December 2013 was 3,700.

**Solution:**

Trading and Profit and Loss Account for the year ended 31 <sup>st</sup> December, 2013)			
Dr.			Cr.
Particulars	₹	Particulars	₹
To Opening Stock	1,250	By Sales	11,800
To Purchases	8,679	Less: Sales Returns	<u>1,659</u>
Less: Purchase Return	<u>1,380</u>	By Closing Stock	3,700
To Wages	1,589		
To Carriage Inwards	300		
To Gross Profit c/d	3,403		
	<u>13,841</u>		<u>13,841</u>
To Depreciation	700	By Gross Profit b/d	3,403
To Insurance	380	By Commission	200
To Printing and Stationery	481		
To Carriage outward	200		
To Salaries	750		
To Discount	300		
To Bad Debts	180		
To Net Profit	612		
	<u>3,603</u>		<u>3,603</u>

**Balance Sheet**  
(as on 31<sup>st</sup> December, 2013)

Liabilities	₹	Assets	₹
Bills Payable	1,084	Cash	1,195
Creditors	3,300	Petty cash	50
Bank Overdraft	6,000	Bills Receivable	3,250
Capital	9,004	Debtors	2,905
Add: Net Profit	<u>612</u>	Closing Stock	3,700
	9,616	Plant and Machinery	6,230
		Furniture	2,670
	<u>20,000</u>		<u>20,000</u>



**2.4. FINAL ACCOUNTS WITH ADJUSTMENTS :** Every adjustment item will come two times or three times. In the final accounts all trial balance items will come only one time in the final accounts. **Treatment of adjustment items in the final accounts:**

Adjustments	Trading account	Profit & loss account	Balance sheet
1. closing stock	Shown in the Cr side of the trading account.		Shown in the asset side
2.outstanding expenses		Shown in the Dr side of trading or profit & loss account by way of addition to the concern expenses.	The liability side of the balance sheet
3.unexpired or prepaid expenses		Shown in the Dr profit and loss account by the way of deduction from concern expenses.	Shown on the asset side of the balance sheet.
4.Accrued income		Showing in the Cr profit & loss account by the way of addition concerning.	Shown on the addition to the asset side balance sheet.
5. Income received in advance		It is shown on the profit and loss account by the way of deduction from concern income.	Shown on the liabilities side of the balance sheet.
6. Depreciation	Shown on the Dr side of Profit and loss account.		Shown on the asset side by way of deduction from the concerned asset.
7. Interest on capital		Shown in the Dr side of profit & loss account	Shown on the liabilities side of the balance sheet by way of adding to the capital.
8.Interest on drawings		Shown on the “cr” side of profit & loss account	Shown on the liabilities side of the balance sheet by way of addition to the drawings which are ultimately redacted from the capital
9.Provision of doubtful debts		Shown on the “Dr” side of P/L account or by way of addition to bad debts (old provision for doubtful debts at the	Shown on the assets side by way of deduction from the sundry debtors ( after deduction of further bad debts) if any

		beginning of the year will be deducted)	
10.Provision for discount on debtors		Shown on the "Dr" side of P/L account	Shown by way of deduction from sundry debtors (after deduction of further bad debts & provision for doubtful debts) on the asset side of the balance sheet
11.additional bad debts		Shown on the "Dr" side by way of addition to the bad debts	Shown the assets side by way of deduction from the amount of sundry debtors.
12.Reserve for a discount on creditors		Shown on the Cr side of P/L account	Shown on the liabilities side of the balance sheet by way of deduction from sundry creditors.
13.Deferred Revenue Expenditure		Shown on the "Dr" side of P/L account (some proportionate amount on deferred revenue expenses)	Shown on asset side by way of deduction from the capitalized expenditure.
15. bad debts		Shown on the debit side of Profit & loss account.	Shown on the assets side of the B/S by way of deduction from sundry debtors.
16.(Interest On Loan)hidden adjustments		Shown on the Dr side of the P/L account by way of addition to the interest on the loan.	Shown on the liabilities side of the balance sheet by way of addition to the loan account.

#### Illustration 8 :

From the following Trial Balance of Ramesh, prepare Trading and Profit & Loss Account for the year ending 31<sup>st</sup> March 2010 and Balance Sheet as on that date.

#### Trial Balance of Ramesh as on 31<sup>st</sup> March 2010

Particulars	Dr (₹)	Cr (₹)
Buildings	50,000	
Capital		96,000
Purchases & Sales	15,000	40,450
Opening Stock ( 1/4/2009 )	8,000	
Debtors & Creditors	10,000	5,000
Drawings	3,500	
Sales Returns & Purchase Returns	1,000	500
Freight	3,250	
Office Salaries	10,000	
Wages	1,200	
Postage & Telegrams	1,000	
Machinery	20,000	
Bills Receivable & Bills Payable	9,000	3,000
Advertisement	4,000	
Cash in Hand	5,000	
Loose Tools	4,000	
	1,44,950	1,44,950



### Adjustments :

1. Closing Stock was valued at Rs 10,000
2. Depreciate Building by 5% and Loose Tools are revalued at ₹3,500
3. Interest on Capital is at 5% and on Drawings is at 10%

### Solution :

#### Trading and Profit & Loss Account of Ramesh for the year ending 31.03. 2010

Particulars	₹	Particulars	₹
To Opening Stock	8,000	By Sales	40,450
To Purchases	15,000	Less : Returns	<u>1,000</u>
Less : Returns	<u>500</u>		39,450
	14,500	By Closing Stock	10,000
To Freight	3,250		
To Wages	1,200		
To Gross Profit c/d	22,500		
	<u>49,450</u>		<u>49,450</u>
To Office Salaries	10,000	By Gross Profit b/d	22,500
To Postage & Telegrams	1,000	By Interest on Drawings	350
To Advertisement	4,000	(@ 10% on Rs. 3,500)	
To Depreciation :			
Building	2,500		
Loose Tools (4,000 - 3,500)	500		
To Interest on Capital			
96000 * 5/100	4,800		
To Net Profit	50		
	<u>22,850</u>		<u>22,850</u>

#### Balance Sheet of Ramesh as on 31<sup>st</sup> March, 2010

Liabilities	₹	₹	Assets	₹	₹
Capital	96,000		Cash in Hand		5,000
Add : Interest (5%)	4,800		Machinery		20,000
	<u>1,00,800</u>		Buildings	50,000	
Add : Net Profit	50		Less : Depreciation (5%)	<u>2,500</u>	47,500
	<u>1,00,850</u>		Loose Tools	4,000	
Less : Drawings	3,500		Less : Depreciation	<u>500</u>	3,500
	<u>350</u>				
Less : Interest on Drawings		97,000	Sundry Debtors		10,000
Sundry Creditors		5,000	Bills Receivable		9,000
Bills Payable		3,000	Closing Stock		10,000
		<u>1,05,000</u>			<u>1,05,000</u>

**Example :** The following balances were extracted from the books of Mohan on 31-12-2013:

Particulars	₹	Particulars	₹
Capital Account	9,000	Purchases	15,000
Furniture	800	Carriage Outwards	200
Creditors	1,600	Salaries	2,000
Premises	13,000	Sales	18,000
Bad Debts	80	Rent Received	800
Cash	40	Discount Allowed	180
Drawings	900	Loan	4,000
Overdraft at Bank	905	Reserve for Bad Debts	100
Debtors	1,500	Expenses	705

**Adjustments:**

- 1) Make provision for bad debts @ 3%.
- 2) Salary due ₹200.
- 3) Stock on 31-12-2013 ₹3,500.
- 4) Write-off 10% from furniture for depreciation.
- 5) Due from tenants rent ₹100.

**Solution:**

**Trading and Profit and Loss Account**  
(for the year ending 31-12-2013)

Dr.	Particulars	₹	Cr.	Particulars	₹
To Purchases		15,000	By Sales		18,000
To Gross Profit c/d		6,500	By Closing Stock		3,500
		<b>21,500</b>			<b>21,500</b>
To Salaries	2,000		By Gross Profit b/d		6,500
Add: Outstanding	200	2,200	By Rent	800	
To Discount Allowed		180	Add: Outstanding	100	900
To Bad Debts	80				
Add: Provision for Bad Debts	45				

Less: Old Reserve	100	25	
To Carriage Outward		200	
To Depreciation on Furniture		80	
To Expenses		705	
To Net Profit (Transferred to Capital)		4,010	
		<b>7,400</b>	<b>7,400</b>

**Balance Sheet**  
(as on 31-12-2013)

Liabilities	₹	Assets	₹
Creditors	1,600	Cash	40
Bank Overdraft	905	Stock	3,500
Outstanding Salary	200	Debtors	1,500
Loan	4,000	Less: Provision for Bad Debts	45
Capital	9,000	Rent Outstanding	100
Add: Net Profit	4,010	Premises	13,000
	<b>13,010</b>	Furniture	800
Less: Drawings	900	Less: Depreciation	80
	<b>12,110</b>		<b>720</b>
	<b>18,815</b>		<b>18,815</b>



**Example :** The account balances of M/s XYZ as on 31.12.13 are as follows:

Purchases	1,62,505	Postage	4,226	Sales	2,52,600
Debtors	50,200	Power	1,350	Bad Debt Reserve	5,200
Opening Stock	26,725	Trade Expenses	5,831	Creditors	30,326
Wages	23,137	Bad debts	525	Bills Payable	3,950
Salaries	5,575	Cash	10,000	Outstanding wages	2,000
Furniture	7,250	Drawings	4,452	Outstanding salaries	700
				Capital	10,000

Loan to Ram @ 10% on 1.9.13 3,000

Prepare trading, P&L A/c and Balance Sheet considering the following:

- 1) Depreciation on furniture @ 10% p.a.
- 2) Bad debts ₹500 and provision for bad debt to be maintained is 5%.
- 3) Goods costing ₹1,500 destroyed by fire and insurance claim has been admitted for ₹1,000.
- 4) Closing stock as on 31.12.13 is ₹12,250.

**Solution:**

**Trading and Profit & Loss Account**  
(for the year ending 31.12.2013)

Dr.			Cr.	
Particular		₹	Particular	₹
To Opening Stock		26,725	By Sales	2,52,600
To Purchase	1,62,505		By Closing Stock	12,250
Less: Loss by Fire	1,500	1,61,005		
To Wages		23,137		
To Power		1,350		
To Gross Profit c/d		52,633		
		<b>2,64,850</b>		<b>2,64,850</b>
To Salary		5,575	By Gross Profit b/d	52,633
To Postage		4,226	By Bad Debts Reserve	5,200
To Trade Expenses		5,831	By Interest on Loan	100
To Bad Debts	525			
Add: New Bad Debts	500			
Add: Provision for Bad Debts	2,485	3,510		
To Depreciation on Furniture		725		
To Accidental Loss (1,500 – 1,000)		500		
To Net Profit		3,75,66		
		<b>57,933</b>		<b>57,933</b>

**Balance Sheet**



(as on 31<sup>st</sup> December 2013)

Liabilities		₹	Assets		₹
Capital	10,000		Cash		10,000
Add: Net Profit	3,75,66		Debtors	50,200	
			Less: Bad Debts	500	
	<u>4,75,66</u>			<u>49,700</u>	
Less: Drawing	4,452	43,114	Less: Provision for Bad Debts	2,485	47,215
Creditors		30,326	Furniture	7,250	
Bills Payable		3,950	Less: Depreciation @ 10%	725	
Outstanding Wages		2,000	Loan to Ram	3,000	6,525
Outstanding Salaries		700	Add: Accrued Interest	100	3,100
			(3,000 * 10% * 4/12)		
			Closing Stock		12,250
			Insurance Claim		1,000
		<b>80,090</b>			<b>80,090</b>

## 2.5. ACCOUNTING PRINCIPLES

Accounting principles

a) ACCOUNTING CONCEPTS

b) ACCOUNTING CONVENTIONS

### a) ACCOUNTING CONCEPTS:

- 1. Money measurement Concept:** This means that the accounting record is made only of those transactions, which can be measured and expressed in terms of money.
- 2. Business Entity Concept:** Accounting assumes that business is a separate entity distinct from its owner under this concept. Business is treated like a legal person owning assets, liabilities without such restrictions the affairs of the business will be mixed with the private affairs and entire picture of the business.

3. **Going Concern Concept:** It means that in accounting a concern that will continue to operate for an indefinitely long period of time.
4. **Cost Concept:** This concept states that assets are recorded at the actual cost to the business and not the market values or some other imaginary values.
5. **Dual Aspects Concept:** Every business transaction involves a dual or double aspect of equal value is called dual aspect concept. The accounting equation is

**Assets – Liabilities + Capital**

6. **Accounting Period Concept:** It means that measuring the financial results of business periodically. The business working life is split into convenient short period of time is called accounting period. The financial position of the business is ascertained at the end of the accounting period by preparing financial statements.
7. **Objective Evidence Concept:** It means that all accounting entities should be evidenced and supported by source documents such as invoice, vouchers, etc.,
8. **Revenue Realization Concept:** It means that revenue is earned by sales of goods or from provisions of services to customers and revenue is to be recognized or considered to be realized only when goods or services transferred to a customer and the customer becomes legally liable to pay for it.
9. **Accrual Concept:** This concept means that when a transaction has been entered into its consequences will certainly follow so all transaction must be brought into record whether they are settled in cash or not.
10. **Matching Concept:** Expenses incurred in the accounting period should be matched with revenue realized in that period. Thus if revenue is realized on goods sold in a period all expensed attributable to that sales should be recorded in that period.

**b) ACCOUNTING CONVENTIONS:**

1. **Full disclosure concept:** This concept deals with the convention that all information which is of material importance should be disclosed in the accounting statements. The companies act, 1956 makes it compulsory to provide all the information in the prescribed form. The accounting reports should disclose full and fair information to the proprietors, creditors, investors, and others. This convention is especially significant in the case of big businesses like Joint Stock Company where there is divorce between the owners and the managers.

- 2. Materiality concept:** Under this concept, the trader records important facts about commercial activities in the form of financial statements. If any unimportant information is to be given for the sake of clarity, it will be given as footnotes.
- 3. Consistency concepts:** The methods or principles followed in the preparation of various accounts should be followed in the years to come. It means that there should be consistency in the methods or principles followed. Or else, the results of one year cannot be conveniently compared with that of another. For example, a company may adopt straight-line method, written down value method, or any other method of providing depreciation on fixed assets. But it is expected that the company follows a particular method of depreciation consistently.
- 4. Conservatism concept:** This convention warns the trader not to take unrealized income into account. That is why the practice of valuing stock at cost or market price, whichever is lower is in vogue. This is the policy of “playing safe”. It takes into consideration all prospective losses to leaves all prospective profits. The convention of conservatism should be applied cautiously so that the results reported are not distorted. Some degree of conservatism is inevitable where objective data is not available.

## **UNIT-2- IMPORTANT QUESTION**

- ✓ Define accounting process. Elucidate the Accounting process/cycle
- ✓ How to prepare ledger, trial balance & final accounts explain with steps?
- ✓ How to post-adjustment items in final accounts:  
Outstanding expenses, b. Prepaid expenses, c. Depreciation, d. Interest on capital, e. Drawings.
- ✓ Briefly write about accounting principles or concepts & conventions.

**Problems:** JOURNAL, LEDGER, TRAIL BALANCE & FINAL ACCOUNTS(Trading & Profit & loss A/C, Balance sheet)

**(17E00104) FINANCIAL ACCOUNTING FOR MANAGERS**

The Objective of the course is to provide the basic knowledge of book keeping and accounting and enable the students to understand the Financial Statements and make analysis financial accounts of a company.

**\* Standard discounting and statistical tables to be allowed in the examinations.**

1. **Introduction to Accounting:** Definition, Importance, Objectives, uses of accounting and book keeping Vs Accounting, Single entry and Double entry systems, classification of accounts – rules of debit & credit.
2. **The Accounting Process:** Overview, Books of Original Record; Journal and Subsidiary books, ledger, Trial Balance, Final accounts: Trading accounts- Profit & loss accounts- Balance sheets with adjustments, accounting principles.
3. **Valuation of Assets:** Introduction to Depreciation- Methods (Simple problems from Straight line method, Diminishing balance method and Annuity method). Inventory Valuation: Methods of inventory valuation (Simple problems from LIFO, FIFO, Valuation of goodwill - Methods of valuation of goodwill.
4. **Financial Analysis -I** Analysis and interpretation of financial statements from investor and company point of view, Liquidity, leverage, solvency and profitability ratios – Du Pont Chart -A Case study on Ratio Analysis
5. **Financial Analysis-II:** Objectives of fund flow statement - Steps in preparation of fund flow statement, Objectives of Cash flow statement- Preparation of Cash flow statement - Funds flow statement Vs Cash flow statement.

**Textbooks:**

- Financial Accounting, Dr.S.N. Maheshwari and Dr.S.K. Maheshwari, Vikas Publishing House Pvt. Ltd.,
- Accountancy .M P Gupta & Agarwal ,S.Chand

**References:**

- Financial Accounting , P.C.Tulisan ,S.Chand
- Financial Accounting for Business Managers, Asish K. Bhattacharyya, PHI
- Financial Accounting Management An Analytical Perspective, Ambrish Gupta, Pearson Education
- Accounting and Financial Management, Thukaram Rao, New Age Internationals.
- Financial Accounting Reporting & Analysis, Stice & Stice, Thomson
- Accounting for Management, Vijaya Kumar, TMH
- Accounting for Managers, Made Gowda, Himalaya
- Accounting for Management , N.P.Srinivasan, & M.Shakthivel Murugan, S.Chand



## UNIT-3

### VALUATION OF ASSETS

#### 3. INTRODUCTION TO DEPRECIATION

**3.1 Valuation of fixed assets:** The broad meaning of Valuation of fixed assets is Valuation of Land, Building, Plant and Machinery, etc.

Valuation of Fixed Assets is undertaken as per the client's requirement. Sometimes Financial Institutions, Banks & Customs authorities also need valuation reports for certain specific assets.

**Definition of 'Asset Valuation:** A method of assessing the worth of a company, real property, security, antique or other item of worth. Asset valuation is commonly performed prior to the sale of an asset or prior to purchasing insurance for an asset.

##### **3.1.1 What is the Difference between Tangible and Intangible Assets?**

- In the world of accounting, understanding the difference between tangible and intangible assets is very important to keep track of a company's property. A tangible asset is anything that has a physical existence, meaning that it can actually be seen or felt by a person. An intangible asset is anything that a company owns that does not have a physical existence, meaning things like information and company logos. Both types of assets are very important parts of a company, and accountants need to be able to recognize both types of these assets.
- One type of tangible assets are known as long-term assets. These are physical things that a company owns and expects to have for a long period of time. The most common examples of these types of assets include land, equipment, and buildings. Over time, all of these assets, except for land, have to be depreciated by an accountant working for the company. This means that they are not worth as much as time goes on as they were originally purchased for.
- Buildings and equipment used by the company are depreciated as time passes. Additionally, companies incur other costs that have to be factored in to their balance sheet. For example, some building costs include the original price of the purchase of the building, any taxes that the company had to pay when purchasing the building, any kind of fees for attorneys and realtors, and any potential costs of having to fix up

or maintain the building. Some equipment costs include the original price that the equipment was bought for, any taxes that had to be paid to purchase the equipment, the costs incurred for installing the equipment, and if the item was delivered, the cost for delivery.

- Land is different from other tangible assets in that it does not depreciate, but instead is held to its historical cost. This means that it remains at the same price on the balance sheet whether the appraisal value goes up or down. It also sees some of the same additional costs as buildings and equipment do. For example, in addition to the price that the land was purchased for, companies have to factor in any potential taxes and any potential fees for people involved with the purchase.

### **3.1.2 Concept of Depreciation:**

a) **Depreciable asset.** These are assets which

- i) are expected to be used during more than one accounting period: and
- ii) have a limited life ; and
- iii) are held by an enterprise for use in the production or supply of goods and services for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

b) **Useful life.** This is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production of similar units expected to be obtained from the use of the asset by the enterprise.

The useful life of a depreciable asset is shorter than its physical life and is:

- (i) pre-determined by legal or contractual limits such as the expiry dates of related lease ;
- (ii) directly governed by extraction or consumption ;
- (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repairs and maintenance policy of the enterprise etc.,
- (iv) Reduced by obsolescence arising from such factors as technological changes, improvement in production methods, change in market demand for the product or service, output of the asset or legal or other restrictions.

**(c) Depreciable Amount.** The amount of depreciable asset is its historical cost, or other amount substituted for historical cost in financial statements, less the estimated residual value.

**(d) Residual Value.** Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset.

### 3.1.3 Cause of depreciation

The following are the main causes of depreciation:

- (i) **Physical Deterioration.** It is caused mainly from wear and tear when the asset is in use and from erosion, rust, rot and decay from being exposed to wind, rain sun and other elements of nature.
- (ii) **Economic Factors.** These may be said to be those that cause the asset to be put out of use even though it is in good physical condition. These arise due to obsolescence and inadequacy. *Obsolescence* means the process of becoming obsolete or out of date. An old machinery though in good physical condition may be rendered obsolete by the introduction of a new model which produces more than the old machinery.
- (iii) **Time factors.** There are certain assets with a fixed period of legal life such as lease, patents, and copyrights. For instance, a lease can be entered into for any period while a patent's life is for some years but on certain grounds this can be extended. Provision for the consumption of these assets is called amortization rather depreciation.
- (iv) **Depletion.** Some assets are of a wasting character perhaps due to the extraction of raw materials from them. These materials are then either used by the firm to make something else or are sold in their raw state to other firms. Natural resources such as mines, quarries and oil wells come under this heading. To provide for the consumption of an asset of a wasting character is called provision for depletion.
- (v) **Accident.** An asset may reduce in value because of meeting of an accident.

### 3.1.4 Difference between Depreciation, Depletion, Amortization and Dilapidations

- *Depreciation* applies to fixed assets, depletion to wasting assets, amortizations to intangible assets and dilapidation to damage due to a building or other property during tenancy. AICPA has given the difference between these terms in the following words:
- “*Depreciation* can be distinguished from other terms, with specialized meaning used by accountants to describe assets cost allocation procedures. Depreciation is concerned with charging the cost of man-made fixed assets to operations (and not with determination of asset value for the balance sheet). Depletion refers to cost allocations for natural resources such as oil and mineral deposits.
- *Amortization* relates to cost allocation for intangible assets such as patent and leaseholds. The use of the term depreciation should also be avoided in connection with the valuation procedures for securities and investments.”

### **3.2. METHODS OF DEPRECIATION:**

Different methods of calculating provision for depreciation are mainly accounting customs which may be used by different concerns taking into consideration their individual peculiarities. The following are the main methods of providing depreciation:

#### **3.2.1 Fixed Installment (or Fixed Percentage on Original Cost or Straight Line) Method**

Under method a fixed percentage of the original value of the asset is written off every year so as to reduce the asset account to nil or to its scrap value at the end of the estimated life of the asset. To ascertain the annual charge under this method all that is necessary is to divide the original value of the asset (minus its residual value, if any) by the number of years of its estimated life i.e.,

$$\text{Depreciation} = \frac{\text{Cost price of asset} - \text{Scrap Value}}{\text{Estimated life of asset}}$$

If, for example, a machine costing Rs. 11, 000/- is estimated to have a life of 10 years and the scrap value is estimated Rs. 1, 000/- at the end of its life, the amount of depreciation would be

$$\text{Rs. } \frac{11,000-1,000}{10} = \text{Rs. } 1,000$$



The amount of depreciation charged during each period of the asset's life is constant. If the charge of depreciation is plotted annually on a graph paper and the points joined together, then the graph will reveal a straight line that is why it is also called as straight line method.

This method is suggested in case of assets where in the service value declines as a function of time and that too at a uniform rate. The repairs, maintenance and revenue also remain more or less constant.

It should be noted carefully that if depreciation is given as some percentage per annum and if the asset is purchased during the accounting year, say on July 1<sup>st</sup> then depreciation for six months is to be charged, if the accounting year closes on 31<sup>st</sup> December.

#### **3.2.1.1 Merits of Fixed Installment Method**

- i. This method is simple to understand and easy to apply.
- ii. It can write down an asset to zero at the end of its working life, if so desired.
- iii. This method is very suitable for those assets which have a fixed life e.g., furniture, fixtures, short leases, patents and copyright and other assets of a small intrinsic value, repair charges are less and the possibility of obsolescence also less.

#### **3.2.1.2 Demerits of Fixed Installment Method**

- i. The charge for depreciation remains constant year after year. The expenses of repairs and maintenance are increasing as the asset grows older. The profit and loss account thus in the later years bears more than its share of valuation.
- ii. It becomes difficult to calculate the depreciation on additions made during year.
- iii. Under this method the depreciation charge remains the same from year to year irrespective of the use of the asset. Thus it does not take into consideration the effective utilization of the asset.
- iv. It is not taking into consideration the interest on capital invested in fixed assets.
- v. It does not provide funds replacement of assets.
- vi. This method tends to report an increasing rate of return on investment in the asset amount due to the fact that the net balance of the asset amount is taken. In spite of these drawbacks, this method is mostly used by firms in U.S.A Canada, U.K., and some firms in India.

**Example 1:** Calculate the rate of depreciation under straight line method (SLM) in each of the following alternative cases:

Case	Purchase Price of Machine (₹)	Expenses to be Capitalized (₹)	Estimated Residual Value (₹)	Expected Useful Life
(a)	80,000	20,000	40,000	4 years
(b)	17,000	3,000	2,000	10 years

**Solution:**

**Step 1:** Calculation of Total Cost of Asset

Total cost of Asset = Purchase Price + Expenses to be capitalized

Case (a) = ₹80,000 + ₹20,000 = ₹1,00,000

Case (b) = ₹17,000 + ₹3,000 = ₹20,000

**Step 2:** Calculation of Amount of Depreciation per year

$$\text{Amount of Depreciation} = \frac{\text{Total Cost of Asset} - \text{Estimated Residual Value}}{\text{Expected Useful Life}}$$

$$\text{Case (a)} = \frac{₹1,00,000 - ₹40,000}{4} = ₹15,000$$

$$\text{Case (b)} = \frac{₹20,000 - ₹2,000}{10} = ₹1,800$$

**Step 3:** Calculation of the Rate of Depreciation under SLM

$$\text{Rate of Depreciation (under SLM)} = \frac{\text{Amount of Depreciation}}{\text{Total Cost of Asset}} \times 100$$

$$\text{Case (a)} = \frac{₹15,000}{₹1,00,000} \times 100 = 15\%$$

$$\text{Case (b)} = \frac{₹1,800}{₹20,000} \times 100 = 9\%$$

**Example 2:** On 1st January 2012, X Ltd. purchased a second-hand machine for ₹52,000 and spent ₹2,000 as shipping and forwarding charges, ₹5,000 as import duty, ₹500 as carriage inwards, ₹1,500 as repair charges, ₹500 as installation charges, ₹400 as brokerage of the middleman and ₹100 for an iron pad. It was estimated that the machine will have a scrap value of ₹2,000 at the end of its useful life which is 20 years. On 30th Sept 2012 repairs & renewals amounted to ₹2,000. On 1st July 2014, this machine was sold for ₹30,600.

**Required:** Prepare the machinery account for the first three years.

**Solution:**

Total Cost of Machinery = Purchase Price + Expenses to be capitalized  
 = ₹52,000 + ₹2,000 + ₹5,000 + ₹500 + ₹1,500 + ₹500 + ₹400 + ₹100  
 = ₹62,000

$$\begin{aligned} \text{Amount of Depreciation p.a.} &= \frac{\text{Total Cost of Machine} - \text{Estimated Scrap value}}{\text{Expected Useful Life}} \\ &= \frac{62,000 - 2,000}{20} = ₹3,000 \end{aligned}$$



Dr. Machinery Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹
01.01.12	To Bank A/c (Cost)	52,000	31.12.12	By Depreciation A/c	3,000
	To Bank A/c (Expenses)	10,000		By Balance c/d	59,000
		<b>62,000</b>			<b>62,000</b>
01.01.13	To Balance b/d	59,000	31.12.13	By Depreciation A/c	3,000
		<b>59,000</b>		By Balance c/d	56,000
01.01.14	To Balance b/d	56,000			<b>59,000</b>
		<b>56,000</b>	01.07.14	By Depreciation A/c	1,500
				By Bank A/c	30,600
				By P&L A/c (Loss)	23,900
					<b>56,000</b>

**Working Notes:**

i) Book Value as on date of sale = ₹56,000 – ₹1,500 = ₹54,500.

ii) Loss on sale = Book Value as on date of sale – Sale proceeds  
= ₹54,500 – ₹30,600 = ₹23,900.

iii) The amount spent on repairs and renewals on 30.09.2012 is of revenue nature and not of capital nature and hence, not debited to machinery account.

**Example 3:** Kumaran Brothers purchased a Machinery on 1.1.2012 for ₹5,00,000. On 1.1.2014 the machinery was sold for ₹4,00,000. The firm charges depreciation at the rate of 15% per annum on Straight Line Method. The books are closed on 31<sup>st</sup> March every year. Prepare Machinery account and Depreciation account.

**Solution:**

Dr. Machinery Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹
1-1-2012	To Bank A/c	5,00,000	31-3-2012	By Depreciation A/c	18,750
		<b>5,00,000</b>		By balance c/d	4,81,250
1-4-2012	To balance b/d	4,81,250			<b>5,00,000</b>
		<b>4,81,250</b>	31-3-2013	By Depreciation A/c	75,000
1-4-2013	To balance b/d	4,06,250		By balance c/d	4,06,250
		<b>4,06,250</b>			<b>4,81,250</b>
			1-1-2014	By Depreciation A/c	56,250
			"	By Bank A/c	3,50,000
					<b>4,06,250</b>

Dr. Depreciation Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹
31-3-2012	To Machinery A/c	18,750	31-3-2012	By Profit & Loss A/c	18,750
31-3-2013	To Machinery A/c	75,000	31-3-2013	By Profit & Loss A/c	75,000
1-1-2014	To Machinery A/c	56,250	1-1-2014	By Profit & Loss A/c	56,250

**Calculation of Profit or Loss on Sale of Machinery**

Date	Particulars	₹
1.1.2012	Cost	5,00,000
31.3.2012	Depreciation $5,00,000 \times \frac{15}{100} \times \frac{3}{12}$	18,750
	Book Value	4,81,250
31.3.2013	Depreciation	75,000
	Book value	4,06,250
1.1.2014	Depreciation $5,00,000 \times \frac{15}{100} \times \frac{9}{12}$	56,250
	Book value	3,50,000
	Sales value	4,00,000
	Profit	50,000

### **3.2.2. Diminishing Balance (or Reducing Installment or Written Down Value) Method**

- Under this method, depreciation is calculated at a certain percentage each year on the balance of the asset which is brought forward from the previous year;
- The amount of depreciation charged in each period is not fixed but it goes on decreasing gradually as the beginning balance of the asset in each year will reduce.
- The charges in initial periods are higher than those in the later periods.
- Overall charges, i.e., amount of depreciation, repairs and maintenance taken together remains equal throughout the life of the asset.
- This method is justified in the cases where 1. there is much uncertainty of revenue in later years and 2.
- there is also increase in repairs and maintenance costs consequently decreasing efficiency and revenues in every succeeding period. It is usually adopted for plant and machinery.

#### **3.2.2.1 Merits of Diminishing Balance Method**

- i. It tends to give a fairly even charge of depreciation against revenue each year. Depreciation is generally heavy during the first few years and is counter – balanced by the repairs being light and in the later years when repairs are heavy this is counter – balanced by the decreasing charge for depreciation. This concept is based on the logic that as an asset grows older, the amount of depreciation goes on decreasing.
- ii. Fresh calculations of depreciation are not necessary as and when additions are made.
- iii. This method is recognized by the income tax authorities in India.
- iv. It does not provide for replacement of asset on the expiry of its useful life.
- v. This method is suitable for plant and machinery, building etc. Where the amount of repairs and renewals increase as the asset grows older and the possibilities of assets are more.

#### **3.2.2.2 Demerits of Diminishing Balance Method**

- i. The original cost of the asset is altogether lost sight of in subsequent years and the asset can never be reduced to zero.



- ii. This method does not take into consideration the asset as an investment and interest is not taken into consideration.
- iii. As compared to the first method, it is difficult to determine the suitable rate of depreciation.

### 3.2.3 DISTINCTION BETWEEN STRAIGHT LINE METHODS AND DIMINISHING BALANCE METHOD

Points of Distinction	Straight Line Method	Diminishing Balance Method
1.Change in Depreciation Amount	Throughout the life of the asset, the amount for depreciation remains to be equal.	Amount of depreciation is more during earlier years of the life of asset than later years and therefore amount is never equal.
2.Balance in Assets A/c	Assets A/c at the expiry of the expected life becomes nil.	The amount never becomes nil.
3.Overall Changes	The overall charge i.e., Depreciation and repairs taken together go on increasing from year to year. In other words the amount depreciation and repairs is relatively less during the earlier years of the life of the asset than later years become repairs go on increasing with use of asset.	Overall charge remains more or less same for every year throughout the life of the asset. Since depreciation goes on decreasing and amount of repairs goes on increasing.
4. Profits	Profits under this method are more during the earlier years of the life of the asset.	Profits are less during earlier years than the later years.

**Example 5:** On 1.1.2010 a machine was purchased for ₹1,00,000. On 30.9.2012 a new machine was purchased for ₹20,000 installation expenses being ₹5,000.

Show the Machinery Account up to 31<sup>st</sup> Dec. 2013 assuming that the rate of depreciation was 10% on written down value method.

**Solution:**

In the books of .....					
Dr.			Machinery Account		Cr.
Date	Particulars	₹	Date	Particulars	₹
2010			2010		
1 Jan.	To Bank A/c	1,00,000	31 Dec.	By Depreciation A/c	10,000
				By Balance c/d	90,000
		1,00,000			1,00,000
2011			2011		
1 Jan.	To Balance b/d	90,000	31 Dec.	By Depreciation A/c	9,000
				By Balance c/d	81,000
		90,000			90,000
2012			2012		
1 Jan.	To Balance b/d	81,000	31 Dec.	By Depreciation A/c	8,725
30 Sept.	To Bank A/c	20,000		(8,100+ 625)	
	To Bank A/c			By Balance c/d	97,275
	(Installation expenses)	5,000			
		1,06,000			1,06,000
2013			2013		
1 Jan.	To Balance b/d	97,275	31 Dec.	By Depreciation A/c	9,728
				By Balance c/d	87,547
		97,275			97,275
2014					
1 Jan.	To Balance b/d	87,547			

**Example 6:** On 1st January 2012, X Ltd. purchased a second-hand machine for ₹58,000 and spent ₹2,000 on its erection. On 1st July 2014, this machine was sold for ₹28,600.

**Required:** Prepare the machinery account of the first 3 years according to the written down value taking the rate of depreciation at 10% p.a.

Machinery Account					
Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
01.01.2012	To Bank A/c	58,000	31.12.2012	By Depreciation A/c	6,000
	To Bank A/c (Erection charges)	2,000		$\left[ 60,000 \times \frac{10}{100} \right]$	
		<b>60,000</b>		By Balance c/d	54,000
01.01.2013	To Balance b/d	54,000			<b>60,000</b>
			31.12.2013	By Depreciation A/c	5,400
				$\left[ 54,000 \times \frac{10}{100} \right]$	
		<b>54,000</b>		By Balance c/d	48,600
01.01.2014	To Balance b/d	48,600			<b>54,000</b>
			01.07.2014	By Depreciation A/c	2,430
				$\left[ 48,600 \times \frac{10}{100} \times \frac{6}{12} \right]$	
		<b>48,600</b>		By Bank A/c	28,600
				By P&L A/c (Loss)	17,570
					<b>48,600</b>

i) Book value as on date of sale = ₹ 48,600 -  $\left( 48,600 \times \frac{10}{100} \times \frac{6}{12} \right)$  = ₹ 46,170

ii) Loss on Sale = Book value - Sale proceeds = ₹ 46,170 - ₹ 28,600 = ₹ 17,570

**Example 7:** A company whose accounting year is the calendar year purchased on 1<sup>st</sup> April, 2011 machinery costing ₹ 30,000. It further purchased machinery on 1<sup>st</sup> October 2011 costing ₹ 20,000 and on 1<sup>st</sup> July 2012, costing ₹ 10,000. On 1<sup>st</sup> January 2013 one third of the machinery which was installed on 1<sup>st</sup> April became obsolete and was sold for ₹ 3,000.

Show how the machinery account would appear in the books of company. The depreciation to be charged at 10% p.a. on written down value method.

**Solution:**

Machinery Account					
Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
2011 April 1	To Bank A/c	30,000	2011 Dec. 31	By Dep. A/c (2,250 + 500)	2,750
Oct. 1	To Bank A/c	20,000	"	By Balance c/d	47,250
		<b>50,000</b>			<b>50,000</b>
2012 Jan. 1	To Balance b/d	47,250	2012 Dec. 31	By Dep. A/c (4,725 + 500)	5,225
July 1	To Bank A/c	10,000		By Balance c/d	52,025
		<b>57,250</b>			<b>57,250</b>
2013 Jan. 1	To Balance b/d	52,025	2013 Jan. 1	By Bank A/c	3,000
			Jan. 1	By P & L A/c	5,325
			Dec. 31	By Dep. A/c	4,370
			"	By Balance c/d	39,330
		<b>52,025</b>			<b>52,025</b>
2014 Jan 1	To Balance b/d	39,330			

### **3.3 ANNUITY METHOD**

1. The fixed Installment Method and the Reducing Balance method of charging depreciation ignore the interest factor.
2. The Annuity Method takes care of this factor. Under this method, the depreciation is charged on the basis that besides losing the original cost of asset, the business also losses interest on the amount used for buying the asset.
3. The terms “Interest” here means the interest which the business could have earned otherwise if the money used in purchasing the asset would have been invested in some other form of investment.
4. Thus, according to this method, such an amount is charged by the way of depreciation which taken into A/c not only the cost of the asset but also interest there on at an accepted rate.
5. The amount of interest is calculated on the book value of the asset, in the beginning of each year.
6. The amount of depreciation is uniform and is determined on the basis of annuity table.  
Follows:  $\text{Rs. } 5,000 \times 2.48685 = \text{Rs } 12,434$  or (say)  $\text{Rs } 12,500$ .



**Example 9:** A firm purchases a lease-hold property for period of five years for ₹10,000 on 1.1.2009. It decides to write off the lease by Annuity method presuming the rate interest at 5% p.a. The Annuity table shows that the annual amount necessary to write off ₹1 at 5% p.a. is ₹0.230976. You are required to prepare the Lease Hold Property Account for five years and show the net amount to be charged to the Profit and Loss account for these five years.

**Solution:**

Dr.			Lease Hold Property Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
<b>2009</b>			<b>2009</b>					
January 1	To Bank	10,000.00	December 31	By Depreciation	2,309.76			
December 31	To Interest	500.00	December 31	By Balance c/d	8,190.24			
		<b>10,500.00</b>			<b>10,500.00</b>			
<b>2010</b>			<b>2010</b>					
January 1	To Balance b/d	8,190.24	December 31	By Depreciation A/c	2,309.76			
December 31	To Interest	409.52	December 31	By Balance c/d	6,290.00			
		<b>8,599.76</b>			<b>8,599.76</b>			
<b>2011</b>			<b>2011</b>					
January 1	To Balance b/d	6,290.00	December 31	By Depreciation A/c	2,309.76			
December 31	To Interest	314.50	December 31	By Balance c/d	4,294.74			
		<b>6,604.50</b>			<b>6,604.50</b>			
<b>2012</b>			<b>2012</b>					
January 1	To Balance b/d	4,294.74	December 31	By Depreciation A/c	2,309.76			
December 31	To Interest	214.74	December 31	By Balance c/d	2,199.72			
		<b>4,509.48</b>			<b>4,509.48</b>			
<b>2013</b>			<b>2013</b>					
January 1	To Balance b/d	2,199.72	December 31	By Depreciation A/c	2,309.76			
December 31	To Interest	110.04						
		<b>2,309.76</b>			<b>2,309.76</b>			

**Statement Showing the Amount Chargeable to the Profit and Loss Account**

Year	Depreciation (Debited)	Interest (Credited)	Net Charge Against Profits
2009	2,309.76	500.00	1,809.76
2010	2,309.76	409.52	1,900.24
2011	2,309.76	314.50	1,995.26
2012	2,309.76	214.74	2,095.02
2013	2,309.76	110.04	2,199.72
	<b>11,548.80</b>	<b>1,548.80</b>	<b>10,000.00</b>

### **UNIT-3 IMPORTANT QUESTIONS**

- ✓ Explain Methods of Depreciation with merits & de-merits?

**Depreciation problems:** Straight Line, Diminishing Balance & annuity Method.