

CASH BOOK

Definition = The book in which all cash transactions (either cash received or paid) are primarily recorded according to dates, is called "Cash Book".

- Features =
- o It plays a dual role. It is both a book of original entry as well as a book of final entry.
 - o It has two identical sides - left hand side (debit side) and right hand side (credit side).
 - o All items of cash receipts are recorded on left hand side and all cash payment items are recorded on right hand side.
 - o The difference between the total of two sides shown cash on hand.
 - o It always shows debit balance. It can never show credit balance.

Advantages/Benefits of Cash Book :-

- o Daily cash receipts and cash payments are easily ascertained.
- o Cash on hand at any time can be ascertained through it.
- o Any error/mistake in this book can easily be detected at the time of verification of cash.
- o Since cash is verified daily, Cash Book is always kept up to date.

Specimen of a Simple Cash Book

DR. (Receipts)					CR. (Payments)				
Date	Particulars	V. No	L-F	Amount Rs.	Date	Particulars	V. No	L-F	Amount Rs.

Types of Cash Book

There are four types of cash book.

- (i) = Single Column Cash Book (Simple Cash Book)
- (ii) = Double Column Cash Book (Cash Book with Cash & Bank Column)
- (iii) = Three Column Cash Book (Cash Book with Cash, Bank & Discount Column)
- iv. Petty Cash Book

Simple or Single Column Cash Book

It is a cash book in which only and only cash transactions are recorded. By single column means, "one amount column" on each side of cash book. One amount column on Debit side in which cash receipt/received is recorded, and one cash column on credit side where cash paid is recorded. The specimen of single/simple cash book is given at page no: 1.

= Please note that when cash book is maintained, there is no need of opening cash account in ledger (as already learned in previous lectures)

Posting Points in Single Column Cash Book.

Following points should be kept in mind while posting the cash book:

- (a) = opening & closing balances are not posted.
- (b) = The items on the debit side of cash book will be posted to the credit of the account in ledger and respective account numbers are noted in ledger folio (L.F) column.
- (c) = The entries appearing on credit side of cash book will be posted to the debit of respective account in the ledger and respective a/c. Numbers are noted in the ledger folio (L.F) column.

Note: Cash book is balanced in the same way as a ledger account.

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Illustration # 1

Enter the following transactions in the Cash Book.

2020

- Feb. 1 - Cash in hand Rs. 2327.
- " 2 - Paid salaries for January Rs. 1500.
- " 5 - Cash received from Saleem Rs. 1360.
- " 6 - Purchased goods for cash Rs. 700.
- " 7 - Cash Sales Rs. 2350.
- " 10 - Paid for office furniture Rs. 1540.
- " 12 - Bought stationery for cash Rs. 86.
- " 17 - Cash paid to Akbar Rs. 890.
- " 20 - Cash purchases Rs. 1230.
- " 24 - Cash received from Saleem Rs. 1200.
- " 28 - Paid office rent Rs. 800.
- " 29 - Cash Sales for last week Rs. 3600.

Solution - -

CASH BOOK

Dr. (Receipts)					Cr. (Payments)				
Date	Particulars	V. No.	L.F.	Amount Rs.	Date	Particulars	V. No.	L.F.	Amount Rs.
2020					2020				
Feb. 1	Balance b/d (opening)	-	-	2327	Feb. 2	Salaries Exp. A/c	-		1500
" 5	Saleem A/c			1360	" 6	Purchase A/c			700
" 7	Sales A/c			2350	" 10	Office Furniture A/c			1540
" 24	Saleem A/c			1200	" 12	Stationery Exp. A/c			86
" 29	Sale A/c			3600	" 17	Akbar A/c			890
					" 20	Purchases A/c			1230
					" 28	Office Rent Exp. A/c			800
					" 29	Balance c/d.			4
				10837					10837
	Cash Bal b/d.			4091					

DOUBLE COLUMN CASH BOOK OR CASH BOOK WITH CASH AND BANK COLUMN.

If a trader keeps a bank account and receipts and payments are made through bank, then it is necessary to have a further column on either side of Cash Book. In that case the Cash Book will have two money columns, one on each side for cash and bank. Such a Cash Book is known as Double Column Cash Book or Cash book with Cash and Bank column.

HINTS FOR RECORDING THE DOUBLE COLUMN CASH BOOK

The following points should be kept in mind while recording the Double Column Cash Book:

(i) OPENING BALANCE

The opening balance of cash in hand and cash at bank are recorded on the debit side in cash and bank column respectively. If the bank balance is credit balance (overdraft) then it will be entered on the credit side in bank column.

(ii) RECEIPT OF CHEQUE OR CASH

If cheque is received and is paid into bank on the same date, it will appear on the debit side of the Cash Book in bank column. If the cheque received is not deposited into bank on the same date, the cheque will be treated as cash, therefore, the amount will appear in the cash column. The receipt of cash will be recorded in cash column in usual manner.

(iii) PAYMENT BY CHEQUE OR CASH

If payment is made by cheque, this will be recorded on the credit side in bank column, because the cash at bank decreased. If the payment is made in cash, this will be recorded in cash column in usual manner.

(iv) BANK CHARGES

Bank charges are recorded on the credit side of Cash Book in bank column because the cash at bank decreases.

(v) CONTRA ENTRIES

The word "Contra" means the opposite side. The entry made on the debit side and the same entry is recorded on the credit side of cash book is called a "contra entry". In order to distinguish the contra entries with other entries letter "C" is put in posting reference column against these entries on either side of the Cash Book. Letter "C" shows that the contra effect of this transaction is recorded on the opposite side. Contra entries may be of the following types:

(a) Cash Deposited into Bank by Office:

When cash is paid into bank by office two entries are required, one on the credit side in the cash column to record the cash paid and the other on the receipt side in the bank column to record the amount received by the bank.

(b) Cash withdrawn from Bank for Office Use:

When cash is withdrawn from the bank for office use, two entries are needed, one on the credit side in the bank column, because this is a payment of cash by the bank and other on the receipt side in the cash column because the cash is received by the office.

(c) Cheque Received and Paid into Bank on any other date:

It has already been explained that if cheque is received and not deposited into bank on the same date, the amount will appear on debit side in the cash column. When the same cheque is deposited on any other date, two entries are required, one on the debit side in the bank column to record the amount received by the bank and other on the credit side in the cash column to record the cash (cheque) paid into bank.

BALANCING THE BANK COLUMN

Whenever it is desired to ascertain the bank balance, the bank columns are totaled on both the sides. If debit side of bank column is bigger than the credit side, the difference represents cash at bank. If credit side of the bank column is bigger

than the debit side the difference represents the "overdrawn balance". Bank account may have a overdrawn balance because by arranging an overdraft with the bank, it is possible that more money may be withdrawn from the bank than what has been deposited.

“The cash columns are balanced as usual.”

Illustrations are solved
below:-

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ILLUSTRATION NO. 2

Following are the cash transactions of M/s Allah Bakhish for the month of June 2013:

2013

- June 1 Balance of cash in hand Rs. 500, Bank overdraft Rs. 3,000.
- 3 Received cheque from Abdul Aziz for Rs. 115.
- 8 Deposited the above cheque into bank.
- 10 Paid by cheque to Nazir Ahmed Rs. 220
- 17 Sold goods for cash Rs. 100.
- 19 Withdrew from bank for office use Rs. 400.
- 22 Deposited cash into bank Rs. 500
- 23 Purchased goods for cash Rs. 300.
- 29 Paid for rent expenses cash Rs. 200.
- 30 Withdrew from bank for personal use Rs. 100.

REQUIRED: Enter the above transactions in two-column Cash Book.

SOLUTION

TWO COLUMN CASH BOOK

Date	Description	L.F.	Cash	Bank	Date	Description	L.F.	Cash	Bank
			Rs.	Rs.				Rs.	Rs.
<u>2013</u>					<u>2013</u>				
Jun 1	Balance b/d		500	—	Jun 1	Balance b/d		—	3,000
3	Abdul Aziz		115	—	8	Nazir Ahmed		—	220
8	Cash	C	—	115	10	Bank	C	115	—
17	Sales	—	100	—	19	Purchases		300	—
19	Bank	C	400	—	22	Cash	C	—	400
22	Cash	C	—	500	23	Bank	C	500	—
31	Balance c/d		—	3,105	29	Rent		200	—
			1,115	3,720	30	Drawings		—	100
								1,115	3,720
					<u>2013</u>				
					July 1	Balance b/d			3,105

ILLUSTRATION NO. 3

Record the following transactions in a Cash Book with Cash and Bank

Column:

2012

- Dec. 1 Cash in hand Rs. 1,532, balance at bank Rs. 18,500.
- 2 Received from K. Kamal Rs. 590.
- 4 Paid salaries for November, by cash Rs. 200.
- 7 Goods purchased, payment made by cheque Rs. 3,200.
- 8 Paid Majid & Sons by cheque Rs. 800.
- 10 Withdrew from bank for office use Rs. 400.
- 14 Deposit into bank Rs. 500.
- 18 Purchased a motor cycle for Rs. 6,500 and drew a cheque for the amount.
- 23 Received a cheque from K. Kamal for Rs. 391.
- 25 Paid wages Rs. 350.
- 28 K. Kamal's cheque paid into bank.
- 31 Bank notifies that K. Kamal's cheque has been dishonored.
- 31 Bank charges as shown in the Pass Book Rs. 15.

SOLUTION

CASH BOOK WITH CASH AND BANK COLUMN

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Dr. (Receipts)

Cr. (Payment)

Date	Description	V.No	L.F.	Cash	Bank	Date	Description	V.No	L.F.	Cash	Bank
				Rs.	Rs.					Rs.	Rs.
<u>2012</u>						<u>2012</u>					
Dec 1	Balance b/d			1,532	18,500	Dec 4	Salaries A/c			200	
2	K. Kamal			590		7	Purchases				3,200
14	Bank	C			500	10	Cash	C			400
14	Cash	C		400		14	Bank	C		500	
23	K. Kamal			391		28	Majid & Sons				800
						18	Motor cycle				6,500
						25	Wages expense			350	
28	Cash	C			391	28	Bank	C		391	
						31	K. Kamal				391
						31	Bank charges				15
						31	Balance c/d			1,532	8,085
				16,701	19,391					16,701	19,391
<u>2013</u>											
Jan 1	Balance b/d			15,260	8,085						

PETTY CASH BOOK:

It is another Cash Book which is maintained in large concerns to reduce the burden of Main Cash Book. For this purpose a junior cashier or petty cashier is given the duty to meet all petty expenses for a fixed period. The petty expenses like Postages, telegrams, tea charges, Printing & stationery etc.

So the some of money kept with junior cashier is called Petty Cash and the Book in which the petty expenses are recorded is termed as Petty Cash Book.

System of Petty Cash Accounting.

(1) Open System: Under this system the Petty Cashier at first receives a fixed sum of money from Head Cashier for meeting petty expenses. As soon as said amount is spent, the head cashier again pays the required sum to the petty cashier.

(2) Fixed Advance System:

Here the petty cashier receives a fixed sum of money from Head Cashier for a fixed period of time, i.e. Rs 2000/- per month. The head cashier will pay Rs 2000/- to the petty cashier every month irrespective of this that whether the petty cashier has spent the total sum or not.

(3) Imprest System: The most efficient & up-to-date system of maintaining Petty Cash Book is the Imprest System of Petty Cash.

Imprest means "the money advanced". Under this system a fixed sum of money is advanced to petty cashier for meeting petty expenses. At the end of certain period i.e. a week, or a month, he submit a statement of petty expenses and head cashier refunds to petty cashier the amount actually spent by him. This refunded amount plus unspent amount lying with petty cashier will be equal to Imprest Cash.

BANK RECONCILIATION STATEMENT

BANK STATEMENT:

Bank regularly sends a statement to its customers showing what balance they have at their bank account. This statement is called a bank statement. The same information may be provided through Pass Book. The Bank Statement summarizes withdrawals, payments as well as deposits and other charges for the period. In fact, Pass Book or the Bank Statement is a true copy of the customer's account maintained in the ledger of the bank. The Pass Book or Bank Statement shows:-

- (i) The balance at the beginning of the month.
- (ii) The deposit made during the month.
- (iii) The cheques paid and other charges debited in the account.
- (iv) The new balance at the end of the month

DISTINCTION BETWEEN CASH BOOK AND PASS BOOK

Although both the Cash Book and Pass Book contain the same transactions, but there are some points of difference between the two, which are given below:

Points of Difference	Cash Book	Pass Book/ Bank Statement
1. Making entries	The customer makes the entries in Cash Book.	The bank makes the entries in Pass Book.
2. Cash deposited	Cash deposited is recorded on the debit side.	Cash deposited is recorded on the credit side.
3. Cheque deposited	Cheque deposited for collection is recorded in Cash Book on the date of deposit.	Cheque deposit for collection is recorded in Pass Book on the date when it is collected.
4. Cash withdrawn	Cash withdrawn is recorded on the Credit Side of Cash Book.	Cash withdrawn out of depositor's account is recorded on the Debit Side.
5. Recording of Cheque issued	When cheque issued to creditor, it is recorded on the date of issue.	In Pass Book cheque is recorded when it is paid to the creditor.

Bank Reconciliation Statement

6. Nature of balance	The debit balance of Cash Book means cash at bank i.e. asset and credit balance means bank overdraft represents liability.	The debit balance of Pass Book means bank overdraft i.e. liability and credit balance means cash at bank represents asset.
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FAVOURABLE AND UNFAVOURABLE BALANCE

Favourable balance means debit balance of Cash Book and Credit balance of Pass Book or Bank Statement.

- (a) When the nature of balance of Cash Book and Pass Book is not mentioned, the balance will be favourable balance i.e. Debit balance of Cash Book and credit balance of Pass Book.
- (b) When the balance of Pass Book and Cash Book is overdrawn, overdraft or unfavourable, it will be credit balance of Cash Book and debit balance of Pass Book.

CAUSES OF DISAGREEMENT OF CASH BOOK AND PASS BOOK

The balance on any date as indicated by bank statement or pass book must be the same as shown by the Cash Book of the depositor. It very rarely happens in practice that the bank balance as shown by the Bank Statement agrees with the balance as shown by the Cash Book. The difference is due to the following reasons:-

1. UN-PRESENTED CHEQUES

These are the cheques which have been issued by the account holder and entered in the Cash Book but have not been presented for payment to the Payee's bank and not entered in the Bank Statement. So the Pass Book will show a balance more than the Cash Book.

2. UN-CREDITED CHEQUES

These are the cheques received from the customers paid into the bank for collection and debited in the bank column of the Cash Book, but the same may not have been credited in the Pass Book on account of the fact that they may not have been cleared within the date of closing. The Cash Book will show a balance more than the Pass Book.

3. MISCELLANEOUS CREDITS:

Miscellaneous credits made by the bank in customer's account are:

- (i) Interest or dividend on investment.
- (ii) Collection of Bills receivable, Notes receivable, cheques, bank drafts. Amount directly deposited into the account by certain debtors etc.
- (iii) Interest on Govt. securities.
- (iv) Interest on deposits.
- (v) Any other direct payment in the bank account such as rent, commission etc.

These credit may not have been debited in the customer's Cash Book due to lack of information, so the Pass Book will show more balance than that of the Cash Book.

4. MISCELLANEOUS DEBITS:

Miscellaneous debits made by the bank in the customer's account are:-

- (i) Interest on overdraft.
- (ii) Bank charges.
- (iii) Collection charges on Bills receivable and cheques.
- (iv) Payment made by the bank on customer's standing order such as insurance premium, trade subscription, etc.
- (v) Payment of bills payable, notes payable.

These debits may not have been credited in the Cash Book due to lack of information. So the Pass Book will show less balance than that of the Cash Book.

5. ERROR AND OMISSION:

There may be the difference between the balances of Cash Book and Pass Book due to an error or omission of any entry on the part of the customer or the bank. These errors may be of the following nature:-

- (i) Error in recording amounts of cheques, for example transposition of figures such as cheque amounting to Rs. 569, has been written in Cash Book as Rs. 596.
- (ii) Entries in wrong columns such as cheques issued by a customer entered in the cash column of the Cash Book.
- (iii) Wrongly debited the customer's account by the bank.
- (iv) The debit or credit side of the Cash Book has been undercasted or overcasted.
- (v) Entries on incorrect sides e.g., cheque issued for advertising has been entered on debit side of Cash Book.

6. DISHONOURD CHEQUES AND BILLS RECEIVABLE:

Cheques and Bills receivable deposited into the bank may have been dishonoured but not credited in the customer's Cash Book due to lack of information. Thus Cash Book will show more balance than the Pass Book.

STEPS TO KNOW THE REASONS OF DISAGREEMENT:

The following steps may be taken to know the reasons of disagreement between the balances as per the Bank column of Cash Book and the Pass Book on any given date:

1. Compare the bank column of Cash Book with the Pass Book on a particular date.
2. Note the items that appear in the bank column of Cash Book but did not appear in the Pass Book.
3. Note those items that appear in the Pass Book but not in Cash Book.

9: Bank Reconciliation Statement

4. The items that appear on debit side of the Cash Book but not in Pass Book will represent cheques paid in but not yet credited in the Pass Book.
- (5) The items that appear on credit side of Cash Book but not in Pass Book will represent cheques issued but not presented for payment.
- (6) The items that appear on debit side of Pass Book but not in Cash Book will relate to the debits in respect of bank charges, commission, interest on overdraft, insurance premium or bill payable paid according to the standing instructions of the customer.
- (7) The items that appear on credit side of Pass Book but not in Cash Book will relate to the credits given if any. Such as interest and dividend on investment, proceeds of bills receivable etc.

DEFINITION OF BANK RECONCILIATION STATEMENT

Bank reconciliation statement is a statement drawn up in order to agree the bank balance as shown by the bank Pass Book with the bank balance as shown by bank column of Cash Book.

Bank reconciliation statement contains a complete and satisfied explanation of the difference in balances as per the Cash Book and Bank Statement. Bank reconciliation statement is prepared when a Bank Statement is received. It is prepared on a stated day.

ADVANTAGES OF BANK RECONCILIATION STATEMENT

Following are the advantages of bank reconciliation statement:

- (i) It shows the correct bank balance position.
- (ii) It helps to detect any mistake in the Cash Book and Pass Book.
- (iii) It prevents paid in recording the banking transactions.
- (iv) It tells any delay in the collection of cheques.
- (v) It ensures better control over banking transactions.

METHODS FOR PREPARING BANK RECONCILIATION STATEMENT

The Bank reconciliation statement is drawn up in either of the following four ways:

1. Starting with Cash Book or Pass Book balance.
2. Reconciliation with adjusted Cash Book or revised Cash Book.
3. Correcting Method or Adjusted Method or double balance method.
4. From the extracts of Cash Book and Pass Book.

1. STARTING WITH CASH BOOK or PASS BOOK

The date at which the statement is being prepared shall always be stated at the head thereof in a clear manner. The balance as shown by the bank column of the Cash Book or Bank Statement is then extracted and used as a starting point, items responsible for the disagreement may be added or deducted as follows:-

STARTING WITH DEBIT BALANCE OF CASH BOOK or CREDIT BALANCE OF PASS BOOK

FIRST CASE: Cheques issued but not presented for payment.

Suppose on 1st July 2004, the bank balance of Mr. Akber is Rs. 3,000. Mr. Akber has issued a cheque in favour of Mr. Anwer for Rs. 500. The cashier of Mr. Anwer will credit the bank account with Rs. 500, but the bank will make a debit entry in the Pass Book when the amount of cheque is paid by the bank. We further suppose that Mr. Anwer has not presented this cheque to the bank for payment, so it will not appear in the Pass Book in such case the balance in Cash Book and Pass Book will appear as under:

Dr.				Cr.			
CASH BOOK							
Date	Particulars	L.F	Amount	Date	Particulars	L.F	Amount
2010 Jul. 1	Balance		Rs. 3,000	2010 Jul. 1	Anwer Balance		Rs. 500
			3,000				2,500
							3,000

PASS BOOK

Date	Particulars	Credit	Debit	DR or CR	Balance
2010 Jul. 1	Balance	—	—	CR	Rs. 3,000

It is clear that the difference of Cash Book and Pass Book balance is due to the amount of cheque which was issued to Mr. Anwer and entered in Cash Book but not presented for payment and not recorded in Pass Book. To reconcile the balance either the sum of Rs. 500 is to be added to the Cash Book or deducted from the Pass Book balance.

SECOND CASE: Cheques deposited but not collected and credited in Pass Book.

Suppose that Mr. Akber received an outstation cheque for Rs. 400 from Mr. Ahmed and deposited the same into bank on 15th July 2004. The cashier of Mr. Akbar will enter this cheque on the debit side of the Cash Book but the bank has not credited the Customer's Account because it has not received the amount of the cheque. Therefore, there is difference between the balances of Cash Book and Pass Book as shown below:

9: Bank Reconciliation Statement

Dr. CASH BOOK (Bank Column) Cr.

Date	Particulars	L.F	Amount	Date	Particulars	L.F	Amount
2004			Rs.	2004			Rs.
Jul. 1	Balance		3,000	July	Balance		3,400
" 15	Ahmed		400				
			3,400				3,400

PASS BOOK / BANK STATEMENT

Date	Particulars	Credit	Debit	DR or CR	Balance
2004					
Jul. 1	Balance	—	—	CR	3,000

To reconcile the two balances the amount of cheque received either must be deducted from the Cash Book balance or added to the Pass Book balance.

THIRD CASE: Credit in Pass Book.

The bank has given credit to Mr. Akber's account with Rs. 300, in respect of the dividend on investment collected by the bank on behalf of Mr. Akber. The intimation of credit has not been received by the cashier of Mr. Akber and therefore, not entered in Cash Book. In such a case the position of two balances will be:

Dr. CASH BOOK (Bank Column) Cr.

Date	Particulars	L.F	Amount	Date	Particulars	L.F	Amount
2004				2004			
Jul. 1	Balance		3,000	July	Balance		3,000
			3,000				3,000

PASS BOOK / BANK STATEMENT

Date	Particulars	Credit	Debit	DR or CR	Balance
2004					
July 1	Balance	—	—	Cr.	3,000
July	Dividend	300	—	Cr.	3,300

To reconcile the two balances the amount of dividend i.e., Rs. 300 is either to be added to the balance of Cash Book or to be deducted from the Pass Book balance. The same will be the case for every credit in the Pass Book not recorded in Cash Book.

FOURTH CASE: Debit in the Pass Book.

Suppose that bank has debited Akber's Account with bank charges Rs. 100 but no entry has been made in Akber's Cash Book because no intimation has been received by his cashier. The position of the balance will be:-

As we know that every transaction either there is an inflow or outflow of money. Transactions are divided into two classes i.e. Capital transactions & Revenue transactions. Transactions having long term effect is called "Capital transactions" and those having short term effect are known as "Revenue transactions". Detailed description is given below

1. CAPITAL AND REVENUE EXPENDITURE

The expenditures of the business are of two kinds:

- A - Capital expenditure ✓
- B - Revenue expenditure

A. CAPITAL EXPENDITURE

Capital expenditure is defined as under:

"It is a capital expenditure if the benefit of the expenditure extends to several trading years". Capital expenditure may include the following expenditures:

- (i) Expenditure incurred on the acquisition of fixed assets, (tangible or intangible) which are related in the business for the purpose of earning profit and not for resale such as land and building, plant and machinery, furniture & fixture, goodwill, patent rights, copy rights, etc.
The cost of fixed assets would include all expenditures necessary up to the time the asset is ready for use, for instance, cost of building purchased would include the price paid to the seller, legal charges and broker's commission. Similarly the cost of machinery would include the purchase price, freight, import duty, cartage, octroi duty, erection and installation charges.
 - (ii) Expenditure which result in an increase in the earning capacity of a business. For instance expenditure incurred in removing the business to a better situation.
 - (iii) Money spent on the improvement of existing assets so as to increase their life or reduce the cost of production, for example, conversion of hand driven machine to power driven machine.
 - (iv) Expenditure incurred on the extension and addition of existing fixed assets, for instance the cost of making additions to building, furniture, machinery, motor vehicles, etc.
 - (v) Any expenditure which is incurred for raising capital money for business, such as commission and brokerage paid to agent for arranging long term loans, discount on issue of shares and debentures.
- Capital expenditure is shown as an asset in the Balance Sheet.

ITEMS OF CAPITAL EXPENDITURE

Following are the most important items of capital expenditure:

- (a) Purchase of factory building.
- (b) Purchase of machine, furniture, motor vehicle, office equipment, etc.
- (c) Cost of goodwill, trade marks, patents, copy right, patterns and designs.
- (d) Expenditure on installation of plant and machinery and other office equipment.
- (e) Additions or extension of existing fixed assets.
- (f) Structural improvement or alterations as to fixed assets which increase their life or earning capacity.

- (g) Preliminary expenses of a limited company.
- (h) Cost of issue of shares and debentures.
- (i) Legal expenses on loans and mortgage.
- (j) Interest on capital during construction period.
- (k) Development expenses in case of mines and plantations.

B. REVENUE EXPENDITURE

(expenses for expired cost)

An item of expenditure whose benefit expires within the year is revenue expenditure. Revenue expenditure does not increase the efficiency of the firm.

The expenditure incurred for the following purposes will be treated as revenue expenditure.

- (i) Expenditure incurred for the purpose of floating assets i.e., asset for resale purpose such as cost of merchandise, raw-material and stores required for manufacturing process.
- (ii) All establishment and other day-to-day expenses incurred in the conduct and administration of the business such as salaries, rent, taxes, postage, stationery, bank charges, insurance, advertisement charges, etc.
- (iii) Expenditure incurred to maintain the fixed assets in proper working condition such as repair, replacement and renewals of building, furniture, machinery, etc.

ITEMS OF REVENUE EXPENDITURE

Following are the important items of revenue expenditure:

- (a) All expenses incurred in the ordinary conduct of business, such as rent, salaries, wages, manufacturing expenses, carriage, commission, legal charges, insurance, advertisement, free samples, salaries, postage expenses, etc.
- (b) Expenses incurred by way of repairs, renewals and replacement for the purpose of maintaining the existing fixed assets of the business in working order.
- (c) Cost of merchandise bought for resale.
- (d) Cost of raw-material and stores purchased for manufacturing process
- (e) Wages paid for manufacture of products for sale.
- (f) Depreciation of assets used in business.
- (g) Interest on loan borrowed for business.
- (h) Freight and cartage paid on goods purchased.
- (i) Cost of oil to lubricate machinery.
- (j) Service of vehicle.
- (k) Any kind of expenditure incurred in defending law suit regarding sale or purchase of goods.

CRITERIA FOR DIFFERENTIATION

It is not easy to decide whether a particular expenditure is of capital nature or that of revenue. Some expenses may lie on the border line and difficulty arise in

P-3 a Capital & Revenue

deciding whether these are capital or revenue. This difficulty can easily be removed by answering the following questions:

- (i) Does the expenditure incurred in acquiring a fixed asset? ✓
- (ii) Does the expenditure incurred for the improvement, addition, installation or erection of the fixed assets?
- (iii) Does the expenditure incurred in increasing the earning capacity of the business?
- (iv) Has it been incurred for raising capital monies for the business?
- (v) Has it been incurred immediately on purchase of second hand asset.

If the answer to any of the above mentioned questions affirmative, the expenditure is capital, but if the answer is negative the expenditure is revenue.

It is always possible to distinguish between capital and revenue expenditure easily due to the following reasons:

- (a) Certain expenses are in the nature of capital for some business and of revenue for others, for instance in an engineering firm, some plant and machinery may have been purchased to earn profit and other may have been purchased for use in the business, again in the case of real estate business, land and building purchased may be treated as revenue expenditure as they may purchased for resale.
- (b) Certain expenses may be said to be partly capital and partly revenue expenditure for example, the combine cost of repairs, alterations and extensions of a fixed asset.

If there is a doubt as to the nature of any item, students should make a note at the foot of their solution as to the method of treatment adopted.

DISTINCTION BETWEEN CAPITAL EXPENDITURE AND REVENUE EXPENDITURE.

Following are the main points of distinction between capital expenditure and revenue expenditure:

Points	Capital Expenditure	Revenue Expenditure
1. Accounting period.	The benefit of capital expenditure is received for many accounting periods.	The benefit of revenue expenditure is received maximum for one accounting period.
2. Recurring	Capital expenditure are of the non-recurring nature.	Revenue expenditure are of recurring nature.
3. Commencement of business.	Capital expenditure are incurred before or after the commencement of business.	Revenue expenditure are incurred always after the commencement of business.

P=4
Capital & Revenue

4. Balance sheet.	Capital expenditure are shown in balance sheet until their benefit is fully exhausted.	Revenue expenditure are not shown in balance sheet.
5. Trading profit and loss account	A portion of capital expenditure (depreciation on fixed assets) is shown in Trading, Profit and Loss Account.	Total amount of revenue expenditure is shown in Trading, Profit and Loss Account.
6. Acquiring asset.	Capital expenditure are incurred to acquire an assets.	No asset is acquired by revenue expenditure except merchandise.
7. Profit	Capital expenditure does not reduce profit.	Revenue expenditure reduces profit.
8. Helps	Capital expenditures help to improve the financial position of the business.	Revenue expenditures help to maintain the business.

ILLUSTRATION NO.1

Write "yes" or "No" against the following statements:

- (i) Preliminary expenses incurred in the formation of company are revenue expenditures.
- (ii) Carriage paid on the purchases of goods is revenue expenditure.
- (iii) Interest on loan borrowed for business is revenue expenditure.
- (iv) Immediate repair to a motor car purchased second-hand is revenue expenditure.
- (v) Ordinary salaries are revenue expenditure.
- (vi) Two cars are purchased for resale purpose. Their cost is capital expenditure.
- (vii) Old furniture repaired at a cost of Rs.1000 in capital expenditure.
- (viii) Carriage paid on goods purchased is capital expenditure.
- (ix) Replacement cost of worn out machinery is capital expenditure.
- (x) Legal expenses incurred in an income tax appeal is capital expenditure.

SOLUTION:

- | | | | | | | | | | |
|------|----|-------|-----|--------|-----|------|-----|-----|-----|
| (i) | No | (ii) | Yes | (iii) | Yes | (iv) | No | (v) | Yes |
| (vi) | No | (vii) | No | (viii) | No | (ix) | Yes | (x) | No |

ILLUSTRATION NO.2

State with reason which items of expenditure would be charged to Capital and which to Revenues:

- (i) Wages paid for installing a new machinery.
- (ii) Carriage paid on merchandise purchased.

Capital & RevenueTopic = (A) Capital and Revenue Receipts.

In the last lecture we have studied only one aspect of a business concern - the spending of money for acquisition of assets and services. (i.e. Capital expenditure & Revenue Expenditure)

Now, other aspect is receipt of money from various sources. When business receives money, it is again of two types.

1 = Capital Receipts 2 = Revenue Receipts.

(1): Capital Receipts:- Receipts which are non-recurring (not received again and again) by nature and whose benefit is enjoyed over a long period are called "Capital Receipts". For example, money brought into business by owner (capital invested), Loan from bank, Sale proceeds of fixed assets, amount received from capital profit. Capital receipt is shown on liabilities side of balance sheet.

(2): Revenue Receipts:- Receipts which are recurring (received again & again) by nature and available for meeting day to day expenses are known as "Revenue Receipts". Examples are, Sale proceeds of goods, Interest received, Commission received, Rent received, dividend received etc.

(B) Capital and Revenue Profits:-

(a) Capital Profits:- It is a profit which is earned on the sale of a fixed asset. For instance, if a machine costing Rs. 10000 is sold for Rs. 12000, the profit of Rs. 2000 is capital profit. Capital Profits appear as liability in Balance Sheet.

(b) Revenue Profits:- This is a profit which is earned during the ordinary course of business (by trading). Revenue Profits are transferred to Income Statement of the year in which they occur.

Capital and RevenueCapital and Revenue Losses:-

Capital Loss:- This is a loss suffered by a business on the sale of a fixed asset or it is incurred on raising capital of a joint stock company. For example if a machinery costing Rs. 50000- is sold for Rs. 45000-, the loss of Rs. 5000- is capital loss. Discount on issue of debentures is also Capital loss.

Revenue Loss:- This is loss made during the ordinary course of day to day business operation such as loss on sale of goods etc. It also appears in the income statement (Profit & loss account) during the year.

Capital & Revenue Payments:-

Firstly note that there is a difference between expenditure and Payment. Expenditure is full payment incurred by the business concern whether paid or not while the term of Payment refers to the amount actually paid. Payments are of two types.

(1) Capital Payments. This is the amount actually paid on account of a capital expenditure for example if a furniture is purchased from Zafar stone for Rs. 15000 by payment of cash.

(2) Revenue Payment :- This is the amount actually paid on account of some revenue expenditure. e.g. food purchased for Rs. 25000.

N.B.

= See & read reasons given in Illustration No: 3 of Book at Page no 455

Ans.

FINAL ACCOUNTS-I

After the preparation of Trial Balance, the next work in accounting is "Final Accounts". The Final Accounts are those accounts which are finally prepared at the end of trading period. Final Accounts include the following:

1. Trading Account
2. Profit and Loss Account
3. Balance Sheet

OBJECTIVES OF FINAL ACCOUNTS

Main objectives of Final Accounts are as under:

- (i) Final accounts are prepared to ascertain the net income earned or loss suffered during a trading period.
- (ii) These accounts are prepared to show the position of assets, liabilities and capital at a particular date.

TRADING ACCOUNT

The Trading Account is an account which shows the result of buying and selling of goods by a trader. It contains in a summarized form all the transactions occurring during a trading period which have direct relation to the goods dealt in by a businessman.

FEATURES OF TRADING ACCOUNT

The salient features of Trading Account are as under:

- (i) Trading Account is prepared on the last day of trading period.
- (ii) It is the first stage of Final Accounts.
- (iii) It contains the direct revenues and direct expenses.
- (iv) Direct expenses are recorded on the debit side and direct revenue on the credit side.
- (v) Direct expenses and direct revenues of current period are taken into account.
- (vi) The balance of Trading Account is either Gross Profit or Gross loss.
- (vii) The Gross Profit or Gross Loss is transferred to Profit & Loss Account.

Dr.

SPECIMEN OF TRADING ACCOUNT

Cr.

Description	Amount	Description	Amount
Opening Stock		Sales	
Purchases		Less: Returns Inward/sales return	
Less: Returns outwards/ Purchases return		Discount on sales	
Discount on purchases		Closing Stock	
<u>Director Expenses:</u>		Gross Loss c/d	
Wages/			
Wages and Salaries			
Carriage (inward)			
Freight (inward)			
Cartage (inward)			
Custom duty/Import Duty			
Excise Duty			
Octroi duty.			
Dock charges and clearing.			
Store consumed			
Manufacturing expenses			
Power/motive power/coal,			
Coke or fuel			
Factory Insurance, rent, light etc.			
Gross Profit c/d			

EXPENSES

Business expenses can be divided into two kinds:

- (i) Direct expenses
- (ii) Indirect expenses

(i) Direct Expenses:

All those expenses which are incurred to convert the raw materials into finished goods or which have been incurred before the goods become ready for sale or has reached the selling point are called direct expenses e.g. wages, motive power, carriage, excise duty, etc.

Direct expenses are shown in the Trading Account.

(ii) Indirect Expenses:

All kinds of expenses incurred during the operation of business are known as indirect expenses. Indirect expenses are sub divided into:

- (a) **Office and administrative expenses** such as office salaries, depreciation, office rent, etc.
- (b) **Selling and distribution expenses** such as salesmen salaries, advertising, discount, etc.
- (c) **Financial and other expenses** such as interest paid, bank charges, repairs, legal charges etc.

All indirect expenses are included in the profit and loss account.

ITEMS OF TRADING ACCOUNT

Now we shall explain the items appearing on the debit and credit sides of Trading Account.

DEBIT SIDE OF TRADING ACCOUNT

- (1) **Opening Stock:** This is the value of goods on hand at the beginning of each trading period. In case of newly started business there will be no opening stock for the first trading period.
- (2) **Purchases:** this item includes both credit and cash purchases out of which returns outwards or purchases return or returns to creditors are deducted in order to arrive at the net purchases.
- (3) **Discount on Purchases:** Discount on purchases is shown by deduction from purchases on the debit side of the trading account.

ITEMS OF DIRECT EXPENSES

- (i) **Wages:** This item means hourly, daily or piece work remuneration paid to workers.
- (ii) **Productive Wages or Manufacturing Wages:** It signifies the wages of factory workers actually engaged in producing or making goods. These are direct expenses and are debited to trading account.
In the examination when only "wages" is mentioned in a Trial Balance, students should take it as productive wages and it should be entered on the debit side of the trading account.
- (iii) **Wages and Salaries:** Where both items are grouped into one account, the salaries are considered as productive and therefore will be debited to Trading Account.
- (iv) **Carriage:** Carriage means the carrying expenses of goods by land. Carriage is sometimes called carriage inward. Carriage inward is the carrying expenses of goods purchased to the godown or shop. It is direct expense and is shown in the trading account.
In the examination if in a Trial Balance only carriage is mentioned the students should treat it carriage inward and debit it to Trading Account.
- (v) **Freight:** Freight denotes the sum paid for conveyance of goods by sea. Like carriage, freight is direct expense and is shown in Trading Account.
- (vi) **Cartage:** The carting charges (e.g. Thela hire) on goods purchased are direct expenses and should be debited to Trading Account.
- (vii) **Custom Duty:** Custom or import duty is the duty paid on the goods imported. Custom duty is a direct expense, therefore, it is debited to Trading Account.
- (viii) **Excise Duty:** It is the duty imposed on goods produced and consumed in the country itself. Being a direct expense excise duty is shown in the Trading Account.
- (ix) **Octroi Duty:** When goods are purchased from another city, the municipal corporation or municipal committee of the purchaser's city charge octroi duty on goods entering the municipal area. It is a direct expense, therefore, charged to the Trading Account.

- (x) **Dock Charges:** These are the dues levied on ships and their cargoes when entering or leaving docks. Dock charges (inward or on purchases) are debited to Trading Account.
- (xi) **Clearing Charges:** Sometimes the importer appoints the clearing and importing agent to take delivery of the imported goods and arrange for their carriage to the importer. The commission paid to this agent is called clearing charges, these charges are direct expenses and therefore, debited to the Trading Account.
- (xii) **Store Consumed:** The item of store consumed denotes lubricating oil, grease, cotton and jute waste consumed are used for running the machinery of a manufacturing concern. It is a direct expense and should be charged to Trading Account.
- (xiii) **Power / Motive Power:** Motive power includes gas, electricity, steam, coal, coke or any other power consumed to run the machinery. It is a direct expense and is debited to Trading Account.
- (xiv) **Factory Insurance, Rent, Light & etc.** Factory insurance, rent, light and etc., are direct expenses and are charged to Trading Account.

CREDIT SIDE OF TRADING ACCOUNT:

- (i) **Sales:** The term sales includes both cash and credit sales of the goods in which the firm deals or the goods which are manufactured by a manufacturing concern. Out of total sales, sales return or return inwards are deducted in order to arrive at the net sales.
- (ii) **Discount on Sales:** Discount on sales is shown by deduction from sales on the credit side of the trading account.
- (iii) **Closing Stock:** Closing stock denotes the goods which have been purchased and debited to Trading Account but have not been sold at the end of current accounting period. *

Usually the closing stock does not appear in the trial balance. It is brought into account by means of a following journal entry.

Stock A/c. (Closing)	Dr.
To Trading A/c	Cr.

The closing stock is valued at cost price or market price which ever is lower.

GROSS PROFIT OR GROSS LOSS

After recording the items in the respective sides of Trading Account, it is balanced. The balance of trading account represents the gross profit or gross loss. If the debit side is bigger than the credit, it is a gross loss, the gross loss will be put on credit (shorter side) to balance the trading account. If credit side is greater than the debit side, it is gross profit, gross profit will be put on debit side to balance the Trading Account. The balance of Trading Account i.e. Gross profit or Gross loss is transferred to Profit and Loss Account. On the other hand, if it is a Gross profit, it is shown on the very top of the credit side of the Profit and Loss Account.

CLOSING ENTRIES FOR TRADING ACCOUNT

In order to ascertain the gross profit or loss various accounts have to be transferred to trading account. This is done by making a journal entry. These journal entries are called "closing entries", as they close the accounts.

For Returns:

As already pointed out, net purchases i.e. purchases less return outwards and net sales i.e. sales less return inwards are shown in trading account. Therefore, first of all return outwards and return inwards accounts will be closed by the following journal entries:

(i) Return outwards / purchases return

Purchases returns A/c..... Dr.
 Purchases A/c.....Cr.

This entry will close the purchases return or return outwards and reduce the amount of purchases.

(ii) Return inwards / Sales return

Sales A/c..... Dr.
 Return inwards/ sales return A/c..... Cr.

This entry will close the sales returns account and reduce the amount of sales.

(iii) For the item on Debit side: The journal entry to close the stock, purchases and direct expenses will be as follows:

Trading A/c..... Dr.
 Stock A/c.....Cr.
 Purchases A/c.....Cr.
 Direct expenses A/c (By name).....Cr.

By this entry the accounts which are transferred to the debit side of Trading Account are closed.

(iv) For the items on Credit side:

The journal entry to close the sales account is as under:

Sales A/c.....Dr.
 Trading A/c..... Cr.
 Closing Stock A/c.....Dr.
 Trading A/cCr.

By this entry a new account, i.e. closing stock is opened.

(v) For Gross Profit:

The gross profit will be transferred to Profit and Loss Account. The journal entry will be

Trading A/c.....Dr. }
 Profit & Loss A/c.....Cr. } With the amount of gross profit.

(vi) For Gross loss:

If there is gross loss the following journal entry will be made to transfer it to Profit and Loss Account.

Profit & Loss A/c.....Dr.	}	With the amount of gross loss.
Trading A/cCr.		

PROFIT AND LOSS ACCOUNT

After having ascertained the gross profit or gross loss from the Trading Account, the next step is to find out the net result of the business. Net result of the business is ascertained from the Profit and Loss Account. Profit and Loss Account is an account which is prepared at the end of a trading period to ascertain net profit or net loss of the business. It is an account in which all nominal accounts are summarized, that is, it is credited with all the nominal accounts showing credit balances and debited with the nominal accounts showing debit balance. After transferring all the nominal accounts from the Trial Balance to the Profit and Loss Account, it is balanced. The difference of the two sides represents either the net profit or the net loss for the period. If the credit side (incomes and gains) exceeds the debit side (expenses and losses) such excess is termed as net profit and if, on the other hand, the debit side exceeds the credit side, the difference is called net loss.

The balance of the Profit and Loss Account is taken to the Balance Sheet. If there is net profit, it is added to the capital, if there is net loss, it is deducted from the capital in the Balance Sheet.

Features of Profit and Loss Account:

The salient features of Profit and Loss Account are as under:

- (i) Profit and Loss Account is second step to the Trading Account.
- (ii) It is prepared on the last day of accounting period.
- (iii) It starts with the Gross Profit or Gross Loss ascertained from Trading Account.
- (iv) Only indirect expenses and indirect revenue are recorded in this account.
- (v) All revenue items of expenses and incomes relating to current period are recorded in it.
- (vi) If the debit side is more than credit side, it indicates net loss and if the credit side is more, it indicates net profit for the period.
- (vii) Net profit is added to and net loss is deducted from capital in the Balance Sheet.

SPECIMEN OF PROFIT AND LOSS ACCOUNT

Name: _____

Profit and Loss Account

For the period ended on: _____

Dr.

Cr.

Description	Amount	Description	Amount
Gross Loss b/d.		Gross profit b/d	
OFFICE & ADMINISTRATIVE EXPENSES:		Interest received	
Salaries		Rent received	
Rent, rates, taxes		Discount received	
Postage & Telegrams		Dividend received	
Office electric charges		Bad debts recovered	
Telephone charges		Miscellaneous revenue	
Printing & Stationery		Net loss: Transferred to Capital A/c	
Discount allowed			
SELLING & DISTRIBUTION EXPENSES			
Carriage outward			
Freight outward			
Advertisement			
Salesmen's salaries			
Commission			
Insurance			
Traveling expenses			
Bad debts			
Packing charges			
FINANCIAL AND OTHER EXPENSES:			
Depreciation			
Repairs			
Audit fee			
Interest paid			
Bank charges			
Legal charges			
Net profit transferred to capital A/c			

GROUPING OF EXPENSES

In Profit and Loss account, the various expenses are grouped into three heads as under:

(i) **Office and administrative expenses:**

The expenses incurred by the administrative and establishment department of the business are called office and administrative expenses. The important examples of these expenses are:

Salaries paid to administrative and office staff, rent of office building, telephone and postage expenses, printing and stationery expenses, etc.

(ii) Selling and distribution expenses:

The expenses incurred for sale of goods, delivery of goods and to increase sales are called selling and distribution expenses. Following are main examples of these expenses:

Salesmen's salaries, commission to salesmen, advertisement expenses, selling supplies, packing charges, free samples etc.

(iii) Financial and other expenses:

Financial expenses means expenses incurred for raising loans, such as interest paid, bank charges, etc. The other expenses may include repairs, depreciation, legal charges, etc.

Difference between Trading Account and profit and Loss Account

Points	Trading Account	Profit and Loss Account
1. Stage	Trading Account is the first stage of Final Accounts.	Profit and Loss Account is the second stage of Final Accounts.
2. Nature of profit	It shows the gross profit or gross loss on sales.	It shows the net profit or net loss of the entire business.
3. Transferring balance	The balance of Trading Account (gross profit or loss) is transferred to Profit and Loss Account.	The balance of Profit & Loss Account (Net profit or loss) is transferred to capital account in Balance Sheet.
4. Expenses	Trading Account includes all those expenses, which are directly connected with the buying of goods or manufacturing goods.	Profit and loss account includes all those expenses which are indirectly connected with the selling of goods.
5. Incomes	It includes only sales income.	It includes all incomes other than sales for the period under consideration.
6. Starts	Trading Account does not start with any balance.	The Profit and Loss Account starts with the balance of trading account i.e. the gross profit or gross loss.
7. Objective of preparation	Trading account is prepared to show the trend of the business.	The profit and loss account is prepared to reflect final outcomes of the business.
8. Preparation	It is prepared before the preparation of the Profit and Loss Account.	It is prepared after the preparation of the Trading Account.

3. BALANCE SHEET

Week #13

Balance Sheet is a statement which shows the assets and liabilities of the business. It is prepared for the purpose of showing the financial position of the business on the last day of the accounting period. A Balance Sheet may be defined as under:

Balance Sheet is a statement of total assets, total liabilities and total capital of a concern on a particular date.

Balance Sheet is so called because it is prepared with the closing balances of ledger accounts at the end of the accounting period.

FEATURES OF BALANCE SHEET

The main features of Balance Sheet are as under:

- (i) Balance Sheet is the last stage of Final Accounts.
- (ii) It is prepared on the last day of the accounting period.
- (iii) It is a statement not an account.
- (iv) It has two sides, the left hand side and the right hand side.
- (v) All the assets owned by the concern are recorded on one side and liabilities and capital on the other side.
- (vi) Both the sides of Balance Sheet are always in agreement.
- (vii) It discloses the financial position and solvency of the concern.
- (viii) It is prepared after the preparation of Trading, Profit and Loss Account.

Heading:

The heading of Balance Sheet contains the following information.

- (i) The name of the business.
- (ii) The name of the statement i.e. Balance Sheet.
- (iii) The date of preparation of Balance Sheet.

A. Classification of Assets:

Assets of the business may be classified as follows:

- (i) Current Assets.
- (ii) Fixed Assets.
- (iii) Contra Assets

(i) Current Assets:

Current assets are those which are held for sale or to be converted into cash after some time. Examples are Cash, Sundry Debtors or Accounts Receivable, Closing Stock, etc. The term current is derived from the fact that such assets constantly change in value through transactions that are entered into. The figures of

sundry debtors (accounts receivable), for instance, changes from day-to-day. These assets are also known as floating or circulating assets.

Fixed Assets:

(ii) Fixed assets are those which are acquired not for sale but for permanent use in the business. Examples are Furniture and Fixture, Plant and Machinery, Land and Building, Investment, Good will, etc.

Contra Assets:

(iii) The accounts operated for adjustment against any asset is known as "Contra Assets". For example accumulated depreciation and allowances for uncollectible.

Classification of Liabilities:

B. The liabilities of a business are classified as follows:

- (i) Current Liabilities
- (ii) Fixed Liabilities or Long Term Liabilities

Current Liabilities:

(i) These are the liabilities which are payable immediately or in the near future. Examples are Sundry creditors (Accounts Payable), Bills payable, expenses payable and capital owners equally etc.

Fixed Liabilities or Long Term Liabilities:

(ii) These are the liabilities which are not payable immediately or in the near future. These liabilities are payable after a long period, therefore, known as long-term liabilities. Examples are long Term Loans, Mortgage payable, Loan from partners, capital/owner equity etc.

Arrangements of Assets and Liabilities:

Assets and Liabilities of the business can be put down in a Balance Sheet in the following three arrangements or ways:

- (i) Order of liquidity or realisability.
- (ii) Order of permanence.
- (iii) Mixed order of arrangement.

Order of Liquidity or Realisability:

(i) Under this method the current and fixed assets of the business are entered in the balance sheet in the order of the degree of ease with which they can be converted into cash and the liabilities in the order of urgency of payment.

The order of liquidity is generally used by the sole traders and partnership firms.

Order of permanence:

(ii) This method is reverse of the liquidity method of arrangement. Under this method the assets are listed according to their permanency i.e. permanent assets

are shown first and less permanent are shown afterwards. Under this method the long term liabilities are shown first and current liabilities are shown afterwards.

The Joint Stock Companies follow the order of permanence.

(iii) Mixed Order of Arrangement:

This method is the combination of the first two methods. Under this method the assets are arranged in order of realisability and the liabilities in order of permanence. This method of arrangement is adopted by banks and other financial institutions.

Various assets and liabilities grouped in the three orders will appear as follows:

In the Order of Liquidity	In the order of Permanence	Mixed Order of Arrangement
<u>Current Assets</u> Cash in hand Cash at Bank Bills Receivable Account Receivable/ Sundry debtors Closing Stock Prepaid Expenses	<u>Fixed Assets</u> Good-will Patents Land & Building Plant & Machinery Furniture & Fixture Investment	<u>Current Assets</u> Cash in hand Cash at Bank Bills Receivable Accounts Receivable/ Sundry debtors Closing Stock Prepaid Expenses
<u>Fixed Assets</u> Investment Furniture & Fixture Plant & Machinery Land & Building Patents Good-will	<u>Current Assets</u> Closing Stock Accounts Receivable Sundry debtors Bills Receivable Cash at Bank Cash in hand	<u>Fixed Assets</u> Investment Furniture & Figure Plant & Machinery Land & Building Patents Good-will
<u>Current Liabilities</u> Bank Overdraft Bills Payable Accounts Payable Expenses Payable	<u>Long Term Liabilities</u> Capital Mortgage Loan Bank Loan	<u>Long Term Liabilities</u> Capital Mortgage Loan Bank Loan
<u>Long Term Liabilities</u> Bank Loan Mortgage Loan Capital	<u>Current Liabilities</u> Expenses Payable Bills Payable Accounts Payable Bank Overdraft	<u>Current Liabilities</u> Expenses Payable Bills Payable Accounts Payable Bank Overdraft

DEPRECIATION, PROVISIONS AND RESERVES

Depreciation is the reduction in value of an asset as a result of fair wear and tear. As an asset loses its value/efficiency we reduce the book valuation of it in line with our estimate of loss. Depreciation is a fairly complex topic, where book-keeping merges into Accountancy. The Accounting principle which motivates Accountants to try different methods of depreciation, is that we are seeking in our Accounting to achieve a 'true and fair view' of the position of the business. This 'true and fair view' requires two things:

- (1) The assets must be valued on the books at a fair value so far as we can estimate it.
- (2) If a loss has been suffered it must be charged against the profits to do otherwise would overstate the profitability of the business. Apply these two rules to the problem of depreciation, we see that if an asset wears out the loss suffered as a result of wear and tear must be written off the profits. At the same time the assets will be reduced in value to show only its present value now that it has been partly worn out.

partly worn out.

DIFFERENT AUTHORS HAVE GIVEN DIFFERENT DEFINITIONS OF DEPRECIATION,
SUCH AS:

"Depreciation is the gradual decrease in the efficiency of an asset expressed in monetary terms because of its usage and wear and tear".

- By the Author of the Book

"Depreciation may be defined as the permanent and continuous diminution in the quality, quantity or value of an asset".

- Pickles

"Depreciation is the gradual and permanent decrease in the value of an asset from any cause".

- Carter

"Depreciation may be defined as a measure of the exhaustion of the effective life of an asset from any cause during a given period".

- Spicer & Pegler

"Depreciation is the diminution in intrinsic value of asset due to use and/or the lapse of time".

- Terminology of the Institute of Cost & Management Accountants, England

"Depreciation is the reduction in value of a fixed asset occasioned by physical wear and tear, obsolescence or the passage of time".

- Northcott & Forsyth

From the above definitions it follows that an asset gradually declines on Account of use and passage of time and this causes permanent reduction in the value and utility of asset. Such reduction in the value or utility of asset is called depreciation. In other words, expired cost or utility of asset is depreciation.

CAUSES OF DEPRECIATION

Depreciation may be of two types:

(1) INTERNAL:

Depreciation which occurs for certain inherent normal causes, is known as internal depreciation. The causes of internal depreciation are:

(a) Wear and Tear:

An asset declines on Account of continued use, e.g. Building, Plant, Machinery etc. Such decline depends on the quantum of use of the asset. If a factory works double-shift instead of single-shift, depreciation on plant and machinery will be doubled. It is obvious that such loss is unavoidable. An asset may be kept in proper working condition through repairs for the time being, but it cannot be done, so permanently. At one time the asset will become unfit for repairs, when it will no longer be usable.

(b) Depletion:

Some asset declines in value proportionate to the quantum of production, e.g. Mine, Quarry etc. With the raising of coal from coalmine the total deposit reduces gradually and after sometime it will be fully exhausted. Then its value will be reduced to nil.

(2) EXTERNAL:

Depreciation caused by some external reasons is called external depreciation. The causes of external depreciation are:

(a) Obsolescence:

Some assets, although in proper working order, may become obsolete. For example, old machine becomes obsolete with the invention of more economical and sophisticated machine whose productive capacity is generally larger and cost of production less. In order to survive in the competitive market the manufacturer must install new machine replacing the old one, Again, it may happen that the articles produced by old machine are no longer saleable in the market on Account of change of habit and taste of the people. In such a case the old machine, although in good working condition, must be discarded and the new one purchased.

(b) Efflux of Time:

Some assets diminish in value on Account of sheer passage of time even though they are not used e.g. Leasehold Property, Patent Right, Copyright etc. Suppose, we take a lease of a house for 10 years for Rs. 10,000. Its annual depreciation will be Rs. 1,000 ($10,000 \div 10$), irrespective of whether the house has been used or not. Because with the end of lease after 10 years, the house will go out of our possession.

(c) Accident:

Assets may be destroyed by abnormal reasons such as, fire, earthquake, flood etc. In such a case the destroyed asset must be written off as loss and a new one purchased.

NEED FOR PROVISION OF DEPRECIATION

The need for provision for depreciation arises for the following reasons:

(1) ASCERTAINMENT OF TRUE PROFIT OR LOSS:

Depreciation is a loss. So unless it is considered like all other expenses and losses, true profit/loss cannot be ascertained. In other words, depreciation must be considered in order to find out true profit/loss of a business.

(2) ASCERTAINMENT OF TRUE COST OF PRODUCTION:

Goods are produced with the help of plant and machinery which incurs depreciation in the process of production. This depreciation must be considered as a part of the cost of production of goods. Otherwise, the cost of production would be shown less than the true cost. Sale price is normally fixed on the basis of cost of production, the sale price will also be fixed at a low level resulting in loss to the business.

(3) TRUE VALUATION OF ASSETS:

Value of assets gradually decreases on account of depreciation. If depreciation is not taken into account, the value of asset will be shown in the books at a figure higher than its true value and hence the true financial position of the business will not be disclosed through Balance Sheet.

(4) REPLACEMENT OF ASSETS:

After some time an asset will be completely exhausted on Account of use. A new asset must then be purchased requiring a large sum of money. If the whole amount of profit is withdrawn from business each year without considering the loss on Account of depreciation, necessary sum may not be available for buying the new asset. In such a case the required money is to be collected by introducing fresh capital or by obtaining loan or by selling some other assets. This is contrary to sound commerce policy.

(5) KEEPING CAPITAL INTACT:

Capital invested in buying an asset, gradually diminishes on Account of depreciation. If loss on Account of depreciation is not considered in determining profit/loss at the year end, profit will be shown more. If the excess profit is withdrawn, the working capital will gradually reduce, the business will become weak and its profit earning capacity will also fall.

(6) LEGAL RESTRICTION:

According to provisions of Companies Ordinance 1984 dividend cannot be declared without charging depreciation on fixed assets. Thus in case of joint stock companies charging of depreciation is compulsory.

DEPRECIATION Vs. FLUCTUATION

Depreciation of asset and fluctuation in its market value are not the same thing. Suppose, a businessman purchases a machine the life of which is estimated at 10 years and charges depreciation accordingly each year. If for certain reasons the market value of that machine decreases by, say 20 %, the businessman need not consider this decrease at all. Because, the productive capacity or the utility of the machine to the business has not been reduced on Account of fall in its market value. So he will not have to suffer any loss, unless he sells the machine. But the machine is not intended for sale - it will be used permanently in the business. So the business will ignore the fall in market price. But depreciation cannot be ignored - it must be considered. Thus we see that there is no relationship between depreciation and fluctuation. The points of distinction between the two are stated below in a tabular form:

Depreciation	Fluctuation
1. It reduces productive capacity or utility of asset.	1. It does not reduce productive capacity or utility of asset.
2. It must occur.	2. It may not occur.
3. It reduces value of asset gradually.	3. The value of asset may rise or fall on Account of fluctuation.
4. Loss by way of depreciation must be considered.	4. Generally, it is not taken into Account. However, in case of current assets permanent fall in price is considered.
5. It is regular loss – it must be charged throughout the working life of asset.	5. It is generally irregular.
6. It always indicates loss.	6. It may indicate either profit or loss. Increase in market value means profit, while decrease means loss.

CHARACTERISTICS OF DEPRECIATION

Depreciation has the following characteristics:

- (1) Depreciation is charged in case of fixed assets only, e.g. Building, Plant and Machinery, Furniture etc. There is no question of depreciation in case of current assets – such as Stock, Debtors, Bills Receivable etc.
- (2) Depreciation causes perpetual, gradual and continuous fall in the value of asset.
- (3) Depreciation occurs till the last day of the estimated working life of asset.
- (4) Depreciation occurs on Account of use of asset. In certain cases, however, depreciation may occur even if the assets are not used, e.g. Leasehold Property, Patent Right, Copyright etc.
- (5) Depreciation is a charge against revenue of an Accounting period.
- (6) Depreciation does not depend on fluctuations in market value of asset.
- (7) The amount of depreciation of an Accounting year cannot be determined precisely – it has to be estimated. In certain cases, however, it may be ascertained exactly, e.g. Leasehold Property, Patent Right, Copyright etc.
- (8) Total depreciation of an asset cannot exceed its depreciable value (cost less scrap value).

METHODS OF CHARGING DEPRECIATION

Total depreciation on an asset must be written off as loss over its working life. There are several methods of determining the amount of depreciation to be charged each year. These methods are discussed below:

1. FIXED INSTALMENT OR STRAIGHT LINE METHOD:

Under this method depreciation of an asset will be equal each year. Annual depreciation is ascertained by the following formula:

$$\frac{\text{Cost} - \text{Scrap Value}}{\text{Estimated Life}}$$

Suppose, cost price of an asset Rs. 2,500, scrap value Rs. 500 and life 5 years. Annual depreciation will be Rs. 400 $\left(\frac{2500 - 500}{5}\right)$.

Depreciation is usually expressed as rate per cent per annum on cost of asset. It is ascertained by the following formula:

$$\frac{\text{Annual Depreciation}}{\text{Cost}} \times 100$$

In the above example the rate of depreciation will be 16% p.a. $\left(\frac{400}{2,500} \times 100\right)$.

The rate may also be calculated on the basis of depreciable value of asset (i.e., cost less scrap value) instead of cost, in which case the formula is:

$$\frac{\text{Annual Depreciation}}{\text{Depreciable Value}} \times 100$$

According to this formula the rate of depreciation in the above example will be:

$$20\% \text{ p.a. } \left(\frac{400}{2,500 - 500} \times 100\right)$$

Under this method the amount of depreciation will be equal every year, since depreciation is charged at a fixed rate on cost of asset. This is the special feature of this method.

If the annual depreciation is plotted on a graph paper, it will show a straight line, since the amount of depreciation is equal every year. This is why this method is also called *Straight line method*.

MERITS:

(i) Simplicity (ii) the asset can be written off to zero value under this method (iii) this method is useful for providing depreciation on Leasehold property, patents and other like assets.

DEMERITS:

This method has following disadvantages:

- (i) With the passage of time efficiency of asset decreases but the amount of depreciation remains the same which does not seem to be justified.
- (ii) If assets are purchased during the year, the calculation of comparative depreciation creates certain problems.
- (iii) No provision is made for interest on amount invested in the purchase of asset.

JOURNAL ENTRIES:

Under this method depreciation is recorded as follows:

- (i) **When depreciation is provided**

Depreciation Account Dr.

Asset Account

(Being depreciation charged on – @ – for the year)

- (ii) When depreciation is transferred to profit and loss Account
 Profit & Loss Account Dr.
 Depreciation Account
 (Being depreciation Account transferred to profit and loss Account)
- (iii) When asset is sold on expiry of its useful life
 Bank Account Dr.
 Asset Account
 (Being scrap of asset sold)
- (iv) If profit is earned on sale of asset
 Asset Account Dr.
 Profit and loss Account
 (Being profit on sale of scrap transferred to profit and loss Account)

ILLUSTRATION NO. 1

On 1st January 2014, a machine was purchased for Rs. 40,000. Rate of depreciation is 10 % p.a. Prepare machinery Account for 3 years when depreciation is charged under fixed installment method.

Solution:

Dr.		MACHINERY ACCOUNT		Cr.	
		Rs.			Rs.
2014 Jan. 1	Bank A/c	40,000	2014 Dec. 31	Depreciation @ 10 % on Rs. 40,000	4,000
				Balance c/d	36,000
		40,000			40,000
2015 Jan. 1	Balance b/d	36,000	2015 Dec. 31	Depreciation @ 10 % on Rs. 40,000	4,000
				Balance c/d	32,000
		36,000			36,000
2016 Jan. 1	Balance b/d	32,000	2016 Dec. 31	Depreciation @ 10 % on Rs. 40,000	4,000
				Balance c/d	28,000
		32,000			32,000
2017 Jan. 1	Balance b/d	28,000			

2. REDUCING BALANCE OR DIMINISHING BALANCE METHOD:

Under this method depreciation is charged at a fixed rate like fixed installment method. But the rate per cent is not calculated on cost of asset as is done under fixed installment method – it is calculated on the book value of asset. The book value of an asset is obtained by deducting depreciation from its cost. The book value of asset gradually reduces on Account of charging depreciation. Since the depreciation rate per cent is applied on reducing balance of asset, this method is called Reducing Balance or diminishing balance method. The calculation of depreciation under this method will be clear from the following table:

Suppose, cost of asset is Rs. 1,000 and rate of depreciation 10 % p.a.

	Rs.
Cost of asset	1,000
Depreciation: I year: 10 % of 1,000	100
Book Value	900
II year: 10 % of 900	90
Book Value	810
III year: 10 % of 810	81
Book Value	729 and so on.

It may be observed that the amount of annual depreciation is gradually reducing. But under fixed installment method the amount remains the same (i.e. Rs. 100).

This method is specially suitable to assets with long life, e.g. Plant & Machinery, Furniture, Motor Car etc.

Since under this method the real cost of using an asset is the depreciation and repair expenses so this method gives better results because in earlier years when the repair expenses are less the depreciation is more. As the asset gets older repair charges on it increases and the amount of depreciation decreases. So the combined effect of both these costs remains almost constant on the profit and loss of each year.

The great weakness of this method is that it takes a very long time to write off an asset to approximately nil, unless a very high rate is used, in which case the burden on earlier years shall be excessive. This method is used by income tax authorities for granting depreciation allowance to assesses.

The calculation of correct rate of depreciation is utmost important under this method. Following formula should be applied under the given condition:

When the cost of asset, residual value and useful life of an asset is given:

$$r = 1 - \left(\frac{S}{C}\right)^{\frac{1}{n}}$$

where

r = rate of depreciation

n = estimated useful life of asset

S = residual value after the expiry of useful life

C = original cost of asset

Thus if $n = 3$ yrs, $S = 64,000$ and $C = 10,00,000$ the rate is:

$$r = 1 - \left(\frac{64,000}{10,00,000}\right)^{\frac{1}{3}} = 1 - \frac{40}{100} = \frac{60}{100} = 60\%$$

ILLUSTRATION NO. 3

On 1st July 2014, Aslam purchased a second-hand machine for Rs. 18,000 and spent Rs. 2,000 on its repairs and installation.

On 30th June 2017 the machinery was disposed off for a sum of Rs. 13,600. Assuming the books are closed on 31st December each year and taking the rate of depreciation at 10 % p.a. on diminishing balance, show the machinery Account.

Solution:

Dr.		MACHINERY ACCOUNT		Cr.	
		Rs.			Rs.
2014			2014		
July 1	Bank A/c	18,000	Dec. 31	Depreciation A/c @	
July 1	Bank A/c	2,000		10 % p.a. on 20,000	
				for 1/2 year	1,000
			Dec. 31	Balance c/d	19,000
		20,000			20,000
2015			2015		
Jan. 1	Balance b/d	19,000	Dec. 31	Depreciation A/c @	
				10 % p.a. on 19,000	
				for one year	1,900
			Dec. 31	Balance c/d	17,100
		19,000			19,000
2016			2016		
Jan. 1	Balance b/d	17,100	Dec. 31	Depreciation A/c @	

2016		19,000			19,000
Jan. 1	Balance b/d		2016		
		17,100	Dec. 31	Depreciation A/c @ 10 % p.a. on Rs. 17,100 for one year	1,710
			Dec. 31	Balance c/d	15,390
		17,100			17,100
2017			2017		
Jan. 1	Balance b/d	15,390	June 30	Depreciation A/c @ 10 % p.a. on Rs. 15,390 for 1/2 year	770
			June 30	Bank A/c	13,600
			June 30	Profit and loss A/c (Loss written off)	1,020
		15,390			15,390

3. YEAR'S DIGITS OR SUM OF YEAR'S DIGITS METHOD:

This method has been introduced by American Accountants recently. It is an improvement over diminishing balance method. Here also the depreciation charge constantly reduces. This method is normally applied to fairly long lived assets. Unlike the diminishing balance method, a constantly decreasing rate is applied on the original cost. Hence the original book value is, like straight line method, reducible to zero. The determination of rate of depreciation is very simple. It simply sums up the years in an asset's lifespan to be used as denominator, and reverses the individual year numbers to be used as numerator. Thus if cost, residual value and life of an asset are:

Rs. 75,000, Rs. 3,000 and 8 years, the denominator will be:

$$1 + 2 + 3 + 4 + 5 + 6 + 7 + 8 = 36$$

The numerators from first to 8th year will respectively be – 8, 7, 6, 5, 4, 3, 2, 1. Applying the rate to the depreciable cost 'original cost – residual value' i.e., Rs. 72,000, the depreciation charges for the first eight years will be:

Year	Opening Book Value	Depreciable Cost	Rate	Depreciation	Total Depreciation	W.D.V.
1	75,000	72,000	8/36	16,000	16,000	59,000
2	59,000	72,000	7/36	14,000	30,000	45,000
3	45,000	72,000	6/36	12,000	42,000	33,000
4	33,000	72,000	5/36	10,000	52,000	23,000
5	23,000	72,000	4/36	8,000	60,000	15,000
6	15,000	72,000	3/36	6,000	66,000	9,000
7	9,000	72,000	2/36	4,000	70,000	5,000
8	5,000	72,000	1/36	2,000	72,000	3,000

Sum of year's digits can be easily computed by the formula:

$$S = \frac{n(n+1)}{2}$$

where:

S = Sum of years

n = number of years of assets useful life.

Applying it when n = 8 years.

$$S = \frac{8(8+1)}{2} = \frac{72}{2} \text{ or } 36$$

METHODS OF DEPRECIATION ACCOUNTING

There are two methods of Accounting of depreciation:

(1) **DEPRECIATION ACCOUNT:**

Under this method, Depreciation A/c is debited and Asset A/c is credited with the amount of annual depreciation. Suppose, the cost of a machine is Rs. 1,000 and its depreciation is 10 % p.a. The entries will be:

		Dr.	Cr.
		Rs.	Rs.
Depreciation A/c	Dr.	100	
Machinery A/c			100
(Being depreciation charged on machinery @ 10 % p.a.)			
Profit & Loss A/c	Dr.	100	
Depreciation A/c			100
(Being transfer of depreciation)			

BALANCE SHEET AS AT

Assets	Rs.	Liabilities	Rs.
Machinery	1,000		
Less Depreciation 100 .	900		

According to the method and object of creation, reserves may be of the following two types:

1. Revenue Reserve
2. Capital Reserve

1. **REVENUE RESERVE:**

Profit earned by a business through its normal activities is determined at the year end through Profit & Loss A/c. The portion of such profit which is not paid to the proprietor, but kept apart, is known as **Revenue Reserve**.

From the viewpoint of its creation revenue reserve may again be classified into two:

- (a) General Reserve
- (b) Specific Reserve