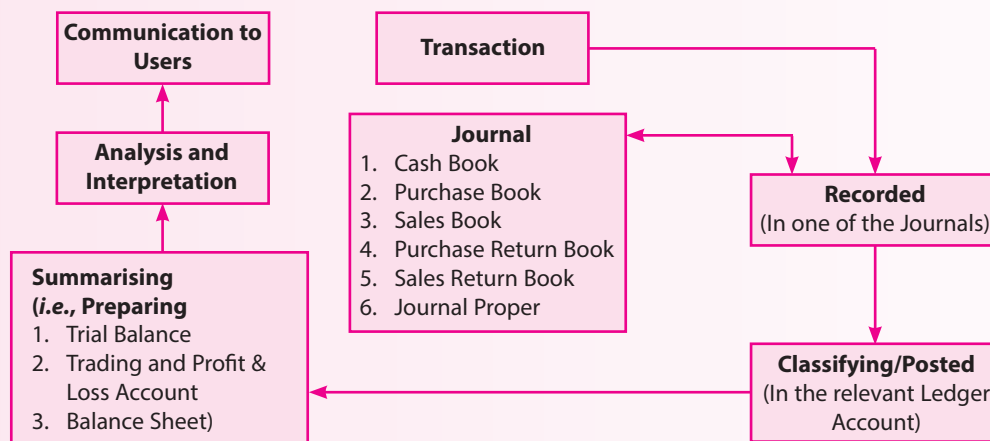


Hari was satisfied that he must switch over from Cash Basis of Accounting to Accrual Based Double Entry System of Accounting since his business was growing rapidly and he will be in continuous need of information about sales, purchase, expenses, creditors, debtors and stock, etc. Besides his income was increasing and, in all probability, will be above the threshold limit of Income Tax. As a result, he will have to file his Income Tax Returns from this year. He decided to maintain his accounts as was suggested by Amit. Considering that it was not an easy step, he again met Amit to know if he will be able to maintain his accounts to which Amit agreed for a monthly fee of ₹ 5,000.

Hari desired to know how will be the accounts maintained and what he has to do. Amit suggested that he will require one hour of his time in which he will visit his place, understand his business and will educate him about the accounting system, important accounting terms and whatever else he would like to know.

Amit first discussed the business nuances and later presented a note on accounting as follows:

The process of accounting is shown in the chart below:



Amit explained that any business transaction entered into by Hari will be recorded in one of the six journals. For example, cash transactions will be recorded in Cash Book, credit purchase of goods in Purchases Book, credit sale of goods in Sales Book and so on. Transactions (which are not recorded in any of the above books) will be recorded in Journal Proper. Such transactions are depreciation providing on assets, drawings of goods by Hari, credit purchase of assets and so on.

He explained that the further process is to transfer (post) recorded transactions in the relevant ledger account maintained in a ledger from where Trial Balance, Trading and Profit & Loss Account and Balance Sheet are prepared. Trading Account shows the gross profit or gross loss while Profit & Loss Account shows the net profit or net loss and Balance Sheet shows the financial position of the business. These statements are collectively called financial statements. Hari was informed that personal transactions are not recorded in the books of account since they do not relate to business.

Thereafter, analysis of financial statements is made and the results are interpreted to know whether the business is in the right direction and if not, corrective steps be taken.

The last step is to communicate the accounting information to the users. At present, there are no users of the accounting information. It may be required at a later stage when the business borrows money or the number of employees increase and information is to be supplied to Government departments. It, however, will be required for filing the Income Tax return.

Hari was satisfied with the explanation and thanked Amit for this elaborate presentation. But his questions did not end here and had few more questions as follows:

- (i) He has often heard his friends referring to terms such as Business Transaction, Capital, Drawings, Revenue from Operations, Income, Goods, Debtors and Creditors, etc. He would like to understand these terms or any other term that is useful in a simple manner.
- (ii) Any other information that is considered appropriate and useful.

Prepare the replies to the queries / questions of Hari.

Answers

- (i) The terms were explained as follows:
 - (a) **Business Transaction:** It is a financial transaction or event entered into by the business say, purchase of goods, sale of goods and providing depreciation on assets, etc.
 - (b) **Capital:** It is the investment in the business by the proprietor and increases by further investment and profit earned during the year. It decreases by loss incurred or drawings made by him during the year.
 - (c) **Drawings:** It is withdrawal by the proprietor for personal use either in cash or goods.
 - (d) **Revenue from Operations:** It is the gross amount received or receivable from the goods sold and / or services rendered during the normal course of its business. Sale of goods and commission earned are revenue from operations while interest received on fixed deposit with bank is not revenue from operations.
 - (e) **Income:** It means revenue from operations *less* expenses incurred to earn the revenue.
 - (f) **Goods:** Goods mean items of physical existence purchased either to resell or to be used for manufacture of items to be sold.
 - (g) **Debtors:** Debtors are the persons or parties to whom goods are sold and / or services are rendered in the normal course of business against which amount is yet to be received.
 - (h) **Creditors:** Creditors are the persons or parties from whom goods are purchased and/or services are taken in the normal course of business against which amount is yet to be paid.
 - (i) **Outstanding Expenses:** Outstanding expenses are the expenses that have been incurred but are yet to be paid. Under the accrual system of accounting, all expenses incurred, whether paid or not, should be accounted to determine correct profit or loss.
 - (j) **Prepaid Expenses:** Prepaid expenses are the expenses that have been paid but its benefit spreads to next year or year. For example, Insurance premium of ₹ 12,000 is paid for one year beginning 1st July, 2022. Since the accounting year closes on 31st March, 2023 and insurance will expire on 30th June, 2023, insurance premium for three months *i.e.*, ₹ 3,000 are for next year. Therefore, in current year they are prepaid expenses.

2

Complete the missing values or information in the following Journal entries:

JOURNAL				
Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2023				
April 10	Cash A/c ...Dr. To ... A/c (Capital introduced by Bimal)		2,00,000	...
April 10	... A/c ...Dr. To ... A/c (Capital introduced by Bimal by cheque)		...	10,00,000
April 15Dr. To ... A/c (Purchase of Exercise Machines by cheque)		75,000	75,000
May 1	... A/c ...Dr. To M/s Fitness Apparels (Apparels purchased)		25,000	25,000
May 1	Bank A/c ...Dr. To ... A/c (Sale of 2 treadmills against cheque during May)		47,500	...
May 1Dr. To ... A/c (Sale of 1 Exercise Machine to Raman)		23,750	23,750
May 1	Cash A/c ...Dr. To Sales A/c (Sale of 5 Exercise Cycles, 2 Weight Bars and 2 Sets Weights during May)		27,075	27,075
May 1	Bank A/c ...Dr. To ... A/c (Advance against sale of 2 treadmills)		47,500	47,500
May 1	Cash A/c ...Dr. To ... A/c (Advance against sale of Exercise Cycle)		1,000	1,000
May 1	... A/c ...Dr. To ... A/c (Amount of Cash Sale and advance deposited in Bank)		28,075	28,075
May 1	Salaries A/c ...Dr. To Bank A/c (...)		15,000	15,000
May 1	... A/c ...Dr. To Cash A/c (Amount withdrawn for personal use)		10,000	10,000

May	1	Electricity Expenses A/c Telephone Expenses A/c To ... A/c (Expenses for the month of May payable)	...Dr. ...Dr.	2,000 1,000	...
May	1	... A/c To Furniture & Fixtures A/c (Depreciation for the month @ 10% p.a.)	...Dr.	30	30

Answer

JOURNAL

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2023				
April 10	Cash A/c To Capital A/c (Capital introduced by Bimal)	...Dr.	2,00,000	2,00,000
April 10	Bank A/c To Capital A/c (Capital introduced by Bimal by cheque)	...Dr.	10,00,000	10,00,000
April 15	Purchases A/c To Bank A/c (Purchase of exercise machines by cheque)	...Dr.	75,000	75,000
May 1	Purchases A/c To M/s Fitness Apparels (Apparels purchased)	...Dr.	25,000	25,000
May 1	Bank A/c To Sales A/c (Sale of 2 treadmills against cheque during May)	...Dr.	47,500	47,500
May 1	Raman To Sales A/c (Sale of 1 Exercise Machine to Raman)	...Dr.	23,750	23,750
May 1	Cash A/c To Sales A/c (Sale of 5 Exercise Cycles, 2 Weight Bars and 2 Sets Weights during May)	...Dr.	27,075	27,075
May 1	Bank A/c To Advance Against Sale A/c (Advance against sale of 2 treadmills)	...Dr.	47,500	47,500
May 1	Cash A/c To Advance Against Sale A/c (Advance against sale of Exercise Cycle)	...Dr.	1,000	1,000
May 1	Bank A/c To Cash A/c (Amount of Cash Sale and advance deposited in Bank)	...Dr.	28,075	28,075
May 1	Salaries A/c To Bank A/c (Salaries for the May month paid by cheque)	...Dr.	15,000	15,000

May	1	Drawings A/c ...Dr. To Cash A/c (Amount withdrawn for personal use)	10,000	10,000
May	1	Electricity Expenses A/c ...Dr. Telephone Expenses A/c ...Dr. To Outstanding Expenses A/c (Expenses for the month of May payable)	2,000 1,000	3,000
May	1	Depreciation A/c ...Dr. To Furniture & Fixtures A/c (Depreciation for the month @ 10% p.a.)	30	30

3

Complete the following Rectification Entries:

JOURNAL				
Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)Dr. To ... (Correction of wrong credit to Sales Account for sale of old furniture, now rectified)		25,000	25,000
(ii)Dr. To ... (Accrued Rent not recorded, now recorded)		5,000	5,000
(iii)Dr. To ... (Short debit in Amit's Account and excess debit in Harish's Account rectified)		2,000	2,000
(iv)Dr. To ... (Cash paid to Arnav recorded in Aman's Account, now rectified)		3,500	3,500
(v)Dr.Dr. To ... (Bill drawn on Rahul was passed through Bills Payable Book, now rectified)		8,000 8,000	16,000

Note: Also mention the nature of errors involved in the above errors.

Answers

S. No.	Debit	Credit	Nature of Error
(i)	Sales A/c	Furniture A/c	Error of Principle
(ii)	Accrued Rent A/c	Rent A/c	Error of Complete Omission
(iii)	Amit's A/c	Harish's A/c	Compensating Errors
(iv)	Arnav's A/c	Aman's A/c	Error of Posting in Wrong Account
(v)	Bills Receivable A/c Bills Payable A/c	Rahul's A/c	Recording in Wrong Subsidiary Book.

4

Gaurav did his Economics (Hons) from Delhi University and his MBA from IIM-Ahmedabad. He got a job with an FMCG company with a good salary. Post working there for 5 years, he started his own business of assembling Toy Cars for Children and named his business "Smiling Toys", on 1st April, 2022 with capital of ₹ 12,50,000. He deposited ₹ 10,00,000 in the firm's name in HDFC bank and remaining amount was retained as cash in hand.

He took on lease premises (having ground and first floors) for an annual rent of ₹ 1,80,000. Factory and shop occupied the ground floor and he used the first floor for residence.

He purchased a Delivery Van on 1st April, 2022 for ₹ 2,50,000. The estimated working life of the van is 10 years at the end of which it is likely to be sold for ₹ 30,000.

An imported toy making machine was also purchased for ₹ 2,00,000. Its estimated useful life was 10 years and at the end of its useful life, is likely to have scrap value of ₹ 25,000. Installation charges of ₹ 15,000 for the machine, were wrongly debited to the Wages Account.

He spent ₹ 25,000 on furnishing his office. 1/4th of all the expenditures on rent, electricity and insurance was attributed to residential portion and the balance for business purpose.

At the year-end on 31st March, 2023, he prepared following financial statements showing his financial performance and financial position as of that date:

Dr. Cr. TRADING AND PROFIT & LOSS ACCOUNT for the year ended 31st March, 2023			
Particulars	₹	Particulars	₹
To Purchases A/c 6,31,000		By Sales A/c 9,00,000	
Less: Returns 45,000	5,86,000	Less: Returns 11,000	8,89,000
To Wages A/c	28,500	By Closing Stock	2,35,500
To Gross Profit c/d	5,10,000		
	11,24,500		11,24,500
To General Expenses A/c	44,000	By Gross Profit b/d	5,10,000
To Rent (1,80,000 × 3/4)	1,35,000	By Discount Received A/c	15,500
To Electricity and Insurance (50,000 × 3/4)	37,500	By Interest A/c	22,000
To Bad Debts A/c	12,500		
To Provisions for Doubtful Debts	2,500		
To Provision for Discount on Debtors	2,375		
To Depreciation on:			
Delivery Van 44,000			
Toy Machine 19,000	63,000		
To Salary A/c	87,000		
To Discount Allowed A/c	23,500		
To Delivery Van Running Expenses	72,000		
To Net Profit transferred to Capital A/c	68,125		
	5,47,500		5,47,500

BALANCE SHEET as at 31st March, 2023

Liabilities	₹	Assets	₹
Creditors	1,08,000	Cash in Hand	4,30,000
General Reserve	50,000	Cash at Bank	2,31,000
Capital	12,00,000	Debtors	50,000
Less: Drawings*	57,500	Less: Provision for Doubtful Debts	2,500
	11,42,500		47,500
Add: Net Profit	68,125	Less: Provision for Discount	2,375
			45,125
		Closing Stock	2,35,500
		Furniture	25,000
		Toy Machine	2,15,000
		Less: Depreciation	19,000
			1,96,000
		Delivery Van	2,50,000
		Less: Depreciation	44,000
			2,06,000
	13,68,625		13,68,625

* Rent 45,000 plus Electricity & Insurance 12,500.

On the basis of the above financial statement, answer the following questions:

Question

Gaurav decided to create a Provision for Doubtful Debts and Provision for Discount on Debtors @ 5% on debtors. Which account should be debited for providing for Doubtful Debts and Provision for Discount on Debtors?

Answer

Profit & Loss Account should be debited for Provision for Doubtful Debts and Provision for Discount on Debtors.

Question

Gaurav has charged as depreciation on Delivery Van ₹ 44,000 during the year instead of charging correct depreciation of ₹ 22,000 (i.e., Cost of Asset – Scrap Value)/Estimated Useful life). Is it a premium or reserve? State the type thereof.

Answer

It's a Secret Reserve.

Question

What is a Secret Reserve?

Answer

Secret Reserve is a reserve which exists but is not shown as a separate item in the Balance Sheet.

Question

How is Secret Reserve created?

Answer

Secret Reserve is created by following methods:

- by providing excessive depreciation.
- by creating excessive Provision for Doubtful Debts.
- by showing Capital Expenditure as Revenue Expenditure.
- by accounting Contingent Liability as a Liability.

Question

State two objections against secret Reserve.

Answer

- (i) Accounting principle of "full disclosure" is violated.
- (ii) Balance Sheet does not show a True and Fair View.

Question

What is "Depreciable Cost"?

Answer

Depreciable Cost = Cost of the Asset – Scrap Value.

Question

Gaurav decided that depreciation would not be provided in case of a loss in a financial year. Is it a correct decision? Give reason.

Answer

No, it is not a correct decision reason being depreciation is a charge against profit. If it is not charged, it will result in showing higher net profit or lower net loss. So, it should be charged in case of loss also.

Question

Gaurav decided that 10% of the profits would be set aside to a reserve for the purpose of strengthening the financial position. Name the reserve which would be created for this purpose.

Answer

General Reserve.

Question

Name the reserves that can be used in distribution of dividend.

Answer

Revenue Reserves, *i.e.*, General Reserve and Surplus, *i.e.*, Balance in Statement of Profit & Loss.

Question

Balance Sheet has an item termed as General Reserve. Can it also be said to be Reserve Fund? Give reason.

Answer

No, it cannot be termed as Reserve Fund because, the amount of reserve if not retained in the business but is invested outside the business, it is termed as Reserve Fund.

Question

What is the purpose for which Gaurav has created Provision for Doubtful Debts?

Answer

It is set aside to meet the possible loss as bad debts out of the debtors. It is provided because of the Prudence or Conservatism Concept which prescribes that anticipated expenses and losses be accounted while anticipated incomes and gains are not. In brief, financial statements should not show better picture than real.

Question

What is the purpose for which Gaurav has created Provision for Discount for Debtors?

Answer

It is set aside to meet the possible loss on discount being allowed to debtors. It is provided because of the Prudence or Conservatism Concept which prescribes that anticipated expenses and losses be accounted while anticipated incomes and gains are not. In brief, financial statements should not show better picture than real.

Question

Suppose Gaurav has earned a profit of ₹ 10,000 on sale of fixed asset. What should be correct accounting treatment of it?

Answer

Profit earned on sale of fixed asset being a capital profit is transferred to Capital Reserve.