

Fundamentals of Accountancy

Book-Keeping:

- *Book-keeping* is a part of accountancy and is concerned with record keeping or maintenance of books of accounts. It is often routine and clerical in nature.
- **R.N. Carter** says, “Book-keeping is the science and art of correctly recording in the books of account all those business transactions that result in the transfer of money or money’s worth”.

Objectives of Book-Keeping

- Permanent record
- Record of income and expenditure
- Record of creditors and debtors
- Record of business assets and liabilities
- Helpful in calculating gross profit/loss and net profit/loss
- Helpful to know about the financial position of the business

Advantages of Book-Keeping

- Undeviating and consistent Record
- Mathematical accurateness of the Accounts
- Net Result of Business Operations
- Calculation of Financial Position of Business
- Calculation of the Progress of Business
- Setting the Selling Price
- Helpful in Taxation
- To fulfil Legal needs

Meaning of Accounting

Accounting refers to the actual process of preparing and presenting the accounts. In other words, it is the art of putting the academic knowledge of accountancy into practice.

- ***American Accounting Association*** defines accounting as “the process of identifying, measuring and communicating economic information to permit informed judgements and decision by users of the information”.

Objectives of Accounting

- Proper maintenance of accounting records
- To ascertain the financial position of the business
- To ascertain the profit/loss of the business
- To communicate the accounting information's
- To fulfil legal requirement

Advantages

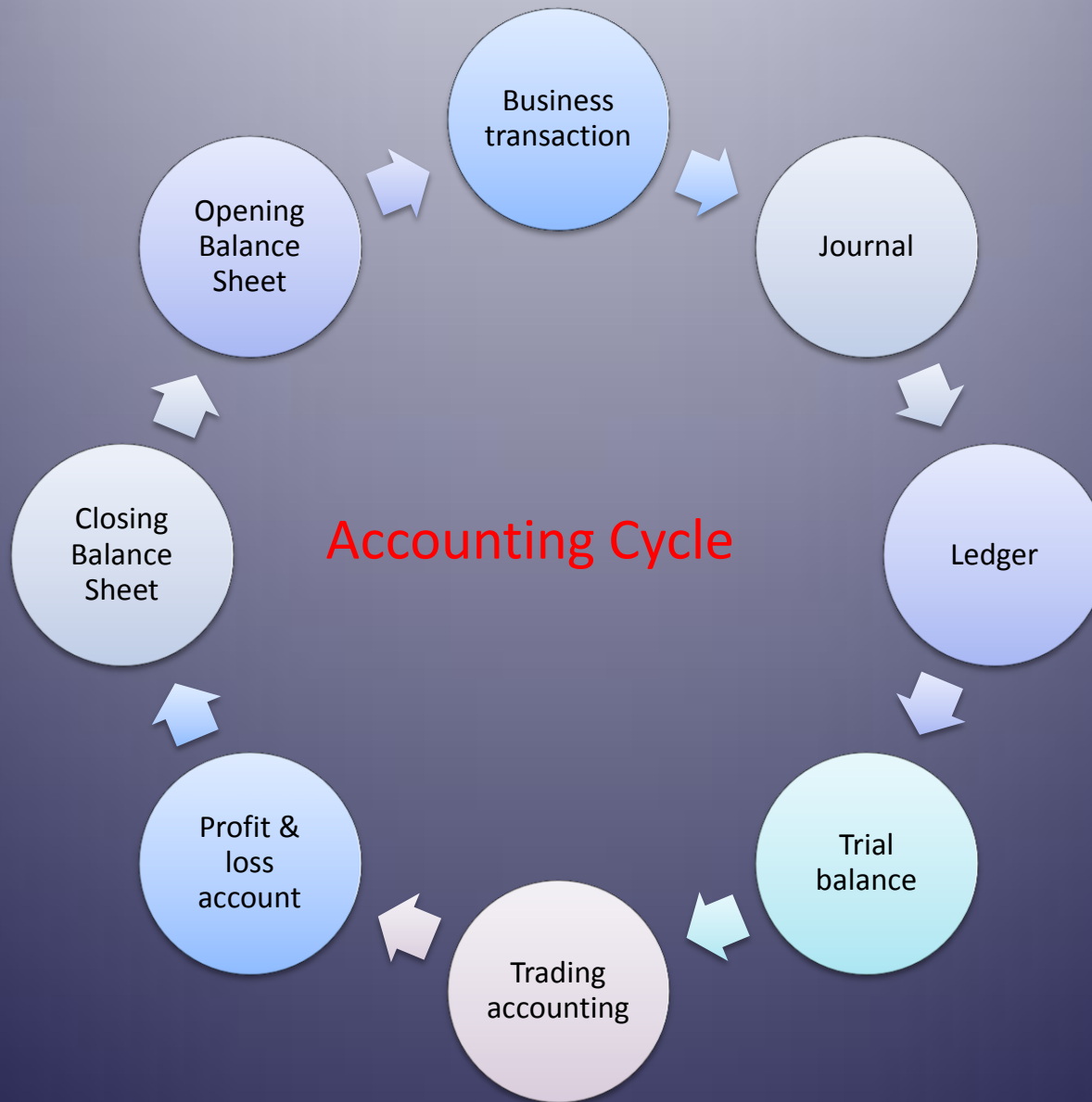
- Complete record of business transactions.
- Provides Information about the profit or loss made by the business
- Provides Information about the liabilities and assets of the business
- Provides useful information
- Helpful in comparative study
- Provides users with factual and interpretive information
- Useful in complying with certain legal formalities

Points of Difference between Book-keeping and Accounting

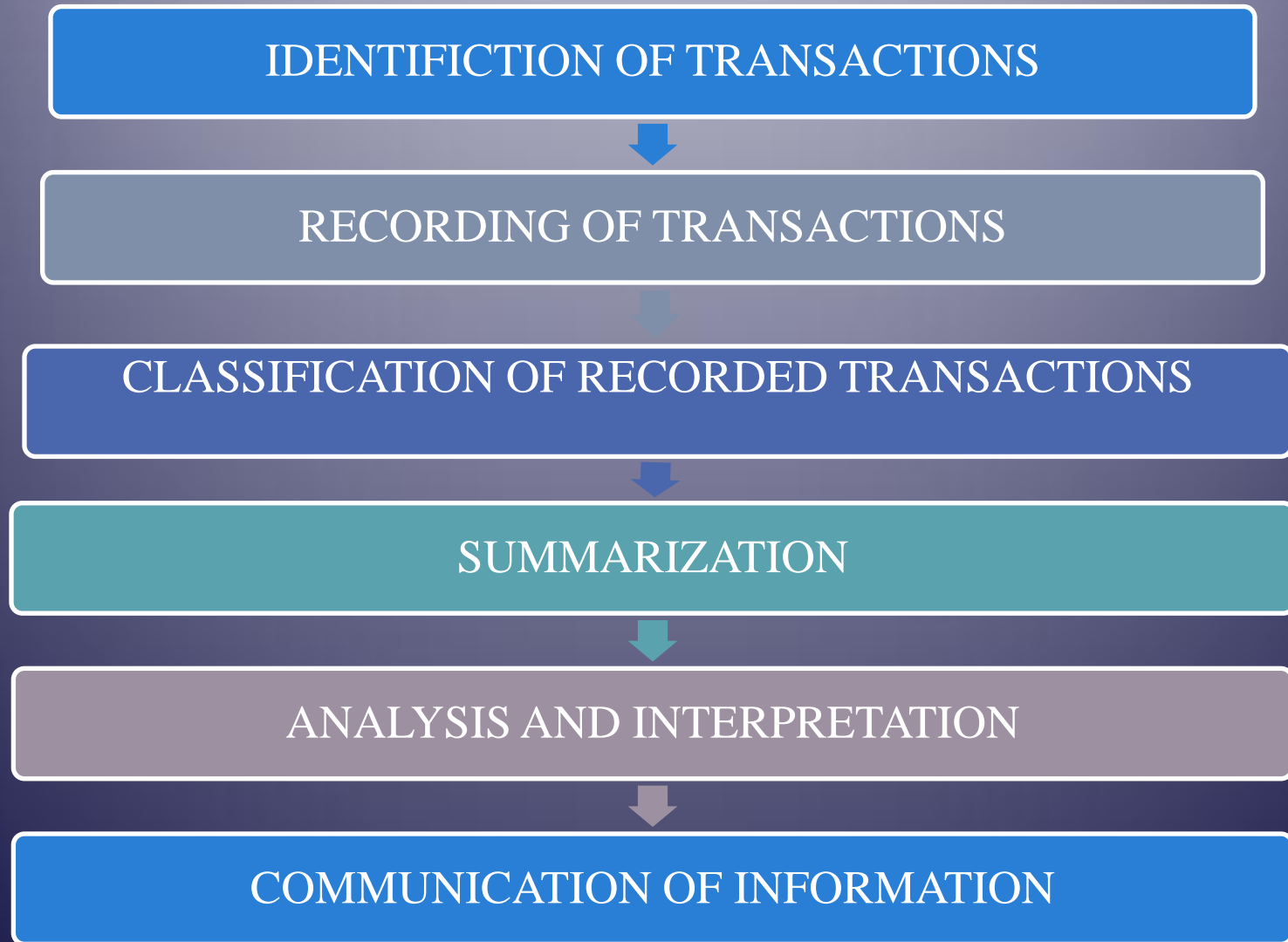
- Recording of Transactions
- Posting of recorded transactions
- Total and Balance of accounts
- Helpful in preparation of Final Accounts
- Helpful in Rectification of Errors
- Skills and Knowledge required
- Liability of concerned person

Accounting Cycle

- An accounting cycle is a complete sequence of accounting process, that begins with the recording of business transactions and ends with the preparation of final accounts.
- The transactions which have completed in the current accounting year, once again come to the starting point – the journal – and they move with new transactions of the next year. Thus, this cyclic movement of the transactions through the books of accounts (accounting cycle) is a continuous process.



Accounting Process/Stages of accounting



ACCOUNTING EQUATION

Accounting equation is a statement of equality between the debits and credits showing that the assets of the business are always equal to the liabilities and capital of the business.

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

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

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

$$\text{Assets} - \text{Capital} - \text{Liabilities} = 0$$

Example: Show the following information in the equation of accounting:

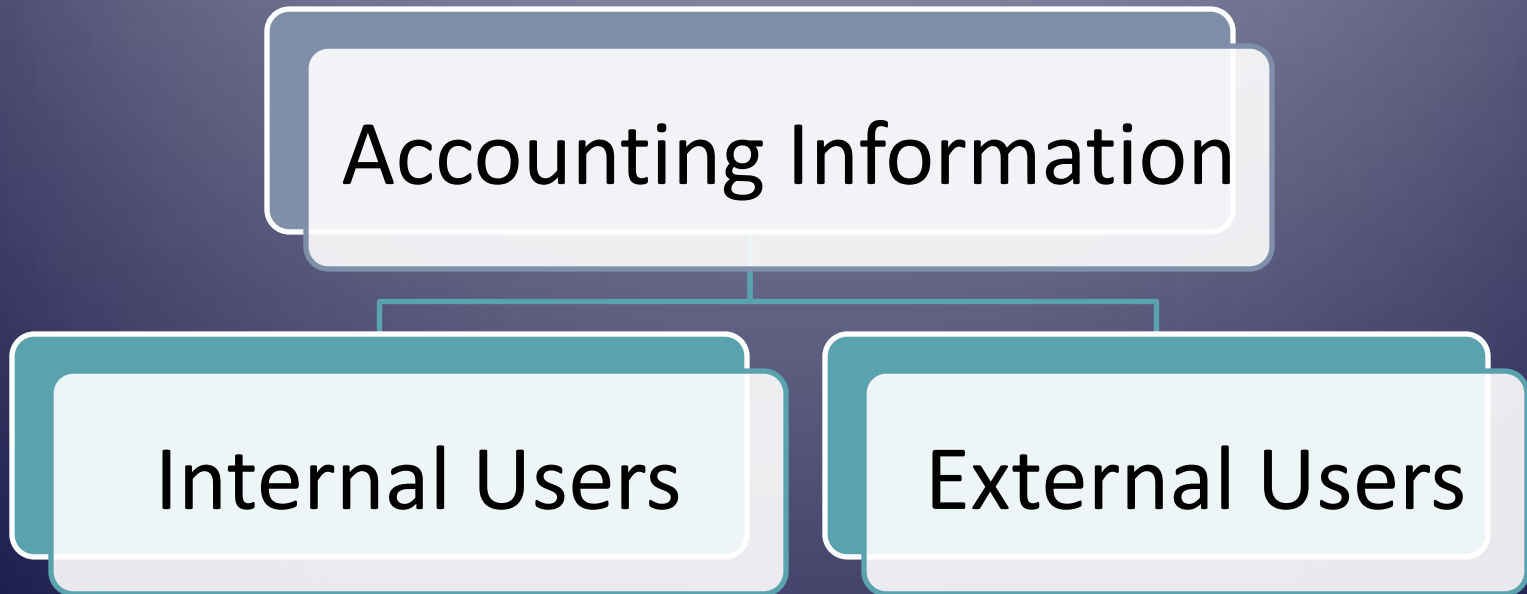
- Business started with cash of Rs. 200000
- Goods Purchased from Mohan of Rs. 20000
- Paid to Mohan Rs. 20000

Answer:

Particulars	Assets	Liabilities + Capital
Business started	200000	0 + 200000
Goods Purchased	$200000 + 20000 = 220000$	$20000 + 200000 = 220000$
Paid to Mohan	$220000 - 20000 = 200000$	$0 + 200000 = 200000$

Users of accounting information's

The main purpose of accounting is to provide desired information's to the actual users of the accounting information.



Internal Users:

- Owners
- Management
- Employees

External Users:

- Creditors
- Banks and Suppliers
- Government
- Investors- present and potential
- Regulatory Bodies
- Researchers
- Financial Analysts

Methods of Accounting

Methods of Accounting

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graph TD; A[Methods of Accounting] --> B[Cash Method of Accounting]; A --> C[Mercantile Method of Accounting];
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Cash Method
of Accounting

Mercantile Method
of Accounting

Limitations of Accounting

- Non-recognition of inflation/deflation in accounting records
- Non-recording of non-monetary transactions
- Influenced by accounting principles
- Influenced by accounting standards
- Ignorance of objectivity factor while doing accounting
- Legal restrictions

Accounting Principles

Accounting principles have been defined by the Canadian Institute of Chartered Accountants as “The body of doctrines commonly associated with the theory and procedure of accounting serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exists. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experience, historical precedent statements by individuals and professional bodies and regulations of Governmental agencies”.

- The American Institute of Certified Public Accountants (AICPA) has advocated the use of the word “Principle” in the sense in which it means “rule of action”.
- The accounting principles should satisfy the following three basic qualities, viz., relevance, objectivity and feasibility.

Accounting Principles

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graph TD; A[Accounting Principles] --- B[Accounting Concepts]; A --- C[Accounting Conventions];
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Accounting
Concepts

Accounting
Conventions

Accounting Concepts

The term 'concept' is used to denote accounting postulates, i.e., basic assumptions or conditions upon the edifice of which the accounting super-structure is based.

- Business Entity Concept
- Historical Cost Concept
- Money Measurement Concept
- Dual Aspect Concept
- Accrual Concept
- Periodicity Concept
- Matching Concept
- Realisation Concept
- Going Concern Concept

Accounting Conventions

Accountants have to follow some customs while doing accounting and these customs are known as conventions. These are also called doctrines.

- Convention of Materiality
- Convention of Conservatism
- Convention of consistency
- Convention of Full Disclosure

Accounting Standards

- The Generally Accepted Accounting Principles in the form of Basic Accounting Concept have been accepted by the accounting profession to achieve uniformity and comparability in the financial statement. This is aimed at increasing the utility of these statements to various users of the accounting information.
- Recognizing this need, the Institute of Chartered Accountants of India (ICAI) constituted an Accounting Standards Board (ASB) in April, 1977 for developing Accounting Standards. The main function of ASB is to identify areas in which uniformity in standards is required and develop draft standards after wide discussion with representative of the Government, public sector undertakings, industry and other organizations.
- Accounting standards are written statements of uniform accounting rules and guidelines or practices for preparing the uniform and consistent financial statements and for other disclosures affecting the user of accounting information.

Accounting Standards issued by ICAI

AS 1	Disclosure of Accounting Policies
AS 2	Valuation of Inventories
AS 3	Cash Flow Statements
AS 4	Contingencies and Events Occurring after the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts
AS 8	Accounting for Research and Development
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The Effects of Changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants

Continued.....

AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 15	Accounting for Retirement Benefits in the Financial Statements of Employers
AS 16	Borrowing Costs
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 19	Leases
AS 20	Earnings per Share
AS 21	Consolidated Financial Statements
AS 22	Accounting for Taxes on Income
AS 23	Accounting for Investments in associates in Consolidated Financial Statements
AS 24	Discontinuing Operations

Continued.....

AS 25	Interim Financial Reporting
AS 26	Intangible Assets
AS 27	Financial Reporting of Interests in Joint Ventures
AS 28	Impairment of Assets
AS 29	Provisions, Contingent Liabilities and Contingent Assets
AS 30	Financial Instruments: Recognition and Measurement
AS 31	Financial Instruments: Presentation
AS 32	Financial Instruments: Disclosures

Double Entry System

Double entry system was introduced to the business world by an Italian merchant named Lucas Pacioli in 1494 A.D. Though the system of recording business transactions in a systematic manner has **originated in Italy, it was perfected in England** and other European countries during the 18th century only i.e., after the Industrial Revolution.

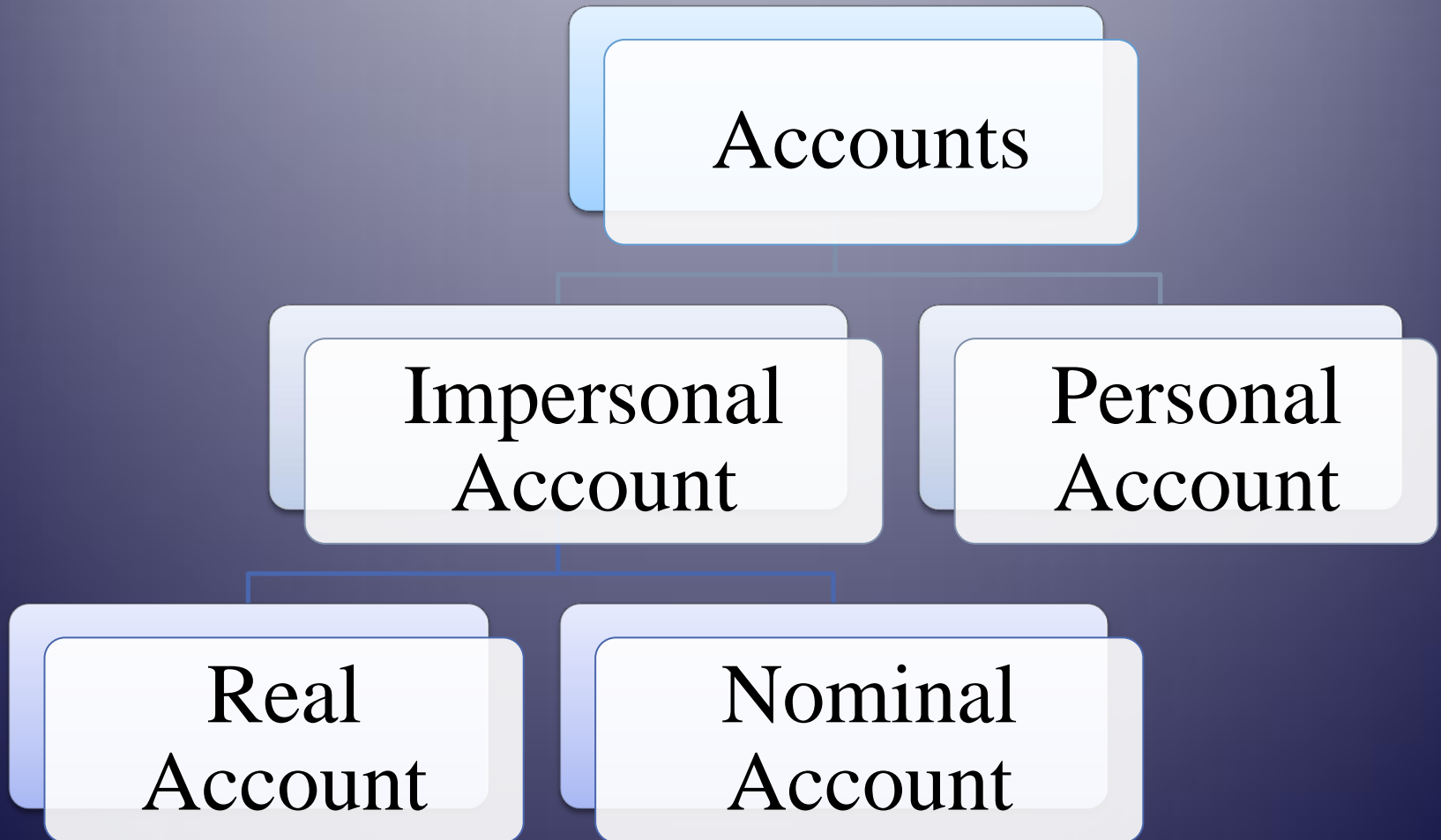
Each transaction, when closely analysed, reveals two aspects. One aspect will be “receiving aspect” or “incoming aspect” or “expenses/loss aspect”. This is termed as the **“Debit aspect”**. The other aspect will be “giving aspect” or “outgoing aspect” or “income/gain aspect”. This is termed as the **“Credit aspect”**. These two aspects namely “Debit aspect” and “Credit aspect” form the basis of Double Entry System.

- According to **J. R. Batliboi** “Every business transaction has a two-fold effect and that it affects two accounts in opposite directions and if a complete record were to be made of each such transaction, it would be necessary to debit one account and credit another account. It is this recording of the two fold effect of every transaction that has given rise to the term Double Entry System”.
- The term ‘debit’ is supposed to have derived from ‘debit’ and the term ‘credit’ from ‘creditable’. For convenience ‘Dr’ is used for debit and ‘Cr’ is used for credit. Recording of transactions require a thorough understanding of the rules of debit and credit relating to accounts. Both debit and credit may represent either increase or decrease, depending upon the nature of account.

Advantages of Double Entry System

- Exact system of accounting
- Full record of transactions
- Checking of the accuracy of accounts is very easy
- Ascertainment of profit or loss
- Ascertainment of financial position
- Complete details for decision-making
- Easy to draw information
- Comparative study
- Finding of fraud

Types of Accounts



Rules of Double Entry System

Accounts	Rules
Personal Accounts	Debit the receiver Credit the giver
Real Accounts	Debit what comes in Credit what goes out
Nominal Accounts	Debit all expenses and losses Credit all incomes and gains

Capital and revenue transactions

- **Capital Expenditure** : Capital expenditure consists of those expenditures, the benefit of which is carried over to several accounting periods. In other words the benefit of which is not consumed within one accounting period. It is non-recurring in nature.
- **Capital Receipt**: Capital receipt is one which is invested in the business for a long period. It includes long term loans obtained from others and any amount realised on sale of fixed assets. It is generally non-recurring in nature.
- **Revenue Expenditure**: Revenue expenditures consist of those expenditures, which are incurred in the normal course of business. They are incurred in order to maintain the existing earning capacity of the business. It helps in the upkeep of fixed assets. Generally it is recurring in nature.

- **Revenue Receipt** : Revenue receipt is the receipt of income which is earned during the normal course of business. It is recurring in nature.
- **Deferred Revenue Expenditure** : A heavy revenue expenditure, the benefit of which may be extended over a number of years, and not for the current year alone is called deferred revenue expenditure. For example, a new firm may advertise very heavily in the beginning to capture a position in the market. The benefit of this advertisement campaign will last for quite a few years. It will be better to write off the expenditure in three or four years and not only in the first year.

Journal

- The word journal comes from the French word “Jour” meaning “day”. It is a book of original or prime entry.
- Journal is a simple book of accounts in which all the business transactions are originally recorded in chronological order and from which they are posted to the ledger accounts at any convenient time.
- Journalling refers to the act of recording each transaction in the journal and the form in which it is recorded, is known as a journal entry.

Format of Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount

- *Date* : In the first column, the date of the transaction is entered. The year and the month is written only once, till they change. The sequence of the dates and months should be strictly maintained.
- *Particulars* : Each transaction affects two accounts, out of which one account is debited and the other account is credited. The name of the account to be debited is written first, very near to the line of particulars column and the word Dr. is also written at the end of the particulars column. In the second line, the name of the account to be credited is written, starts with the word 'To', a few space away from the margin in the particulars column to the make it distinct from the debit account.
- *Ledger Folio (L.F)*: All entries from the journal are later posted into the ledger accounts. The page number or folio number of the Ledger, where the posting has been made from the Journal is recorded in the L.F column of the Journal. Till such time, this column remains blank.
- *Debit Amount*: In this column, the amount of the account being debited is written.
- *Credit Amount* : In this column, the amount of the account being credited is written.
- *Narration* : After each entry, a brief explanation of the transaction together with necessary details is given in the particulars column with in brackets called narration. The words 'For' or 'Being' are used before starting to write down narration.

Example: Journalize the following transactions in the books of Mohal Lal & Co.:

2012 Jan. 1	Business started	Rs. 300000
3	Machinery purchased	200000
5	Goods purchased	100000
6	Goods sold to Rakesh	80000
10	Received cash from Rakesh	80000
11	Goods purchased from Mukesh	500000
13	Goods sold to Mohan and received a cheque	300000
15	Goods purchased and received cash discount of Rs. 1200	46200
20	Goods sold to Mahesh	100000
23	Mahesh send a cheque in full settlement	98500
25	Stationary purchased	2500
27	Telephone bill paid	4500
30	Wages paid	7500

Answer:

Journal Entries in the books of Mohan Lal & Co.

Date	Particulars	L. F.	Debit Amt.	Credit Amt.
2012 JAN. 1	Cash A/c Dr. To Capital A/c (Being business started)		300000	300000
3	Machinery A/c Dr. To Cash A/c (Being machinery purchased)		200000	200000
5	Purchase A/c Dr. To Cash A/c (Being goods Purchased)		100000	100000
6	Rakesh's A/c Dr. To Sales A/c (Being goods sold to Rakesh)		80000	80000

10	Cash A/c To Rakesh's A/c (Being Cash received)	Dr.	80000	80000
11	Purchase A/c To Mukesh's A/c (Being goods purchased on credit)	Dr.	500000	500000
13	Bank A/c To Sales A/c (Being goods sold for cash and received cheque in settlement)	Dr.	300000	300000
15	Purchase A/c To Cash A/c To Discount A/c (Being goods Purchased and get cash discount)	Dr.	46200	45000 1200
20	Mahesh's A/c To Sales A/c (Being goods sold on credit)	Dr.	100000	100000

23	Cash A/c Discount A/c To Mahesh's A/c (Being cash received in full settlement and discount allowed)	Dr. Dr.	98500 1500	100000
25	Stationary A/c To Cash A/c (Being stationary purchased and paid in cash)	Dr.	2500	2500
27	Telephone A/c To Cash A/c (Being telephone bill paid for the month of January)	Dr.	4500	4500
30	Wages A/c To Cash A/c (Being wages paid)	Dr.	7500	7500

Ledger

- Ledger is a main book of account in which various accounts of personal, real and nominal nature, are opened and maintained.
- A ledger account may be defined as a summary statement of all the transactions relating to a person, asset, expense, or income or gain or loss which have taken place during a specified period and shows their net effect ultimately.
- Posting refers to the process of entering in the ledger the information given in the journal.
- Balancing of the ledger is done at the end of the specified period. In this process, the total of debit as well as credit is done and in the lighter side the difference is written.

Format

Dr.

Name of the Account

Cr.

Date	Particulars	J. F.	Amount	Date	Particulars	J. F.	Amount
	To name of the account to be credited				By name of the account to be debited		

Subsidiary books

- The main journal is sub-divided in such a way that a separate book is used for each category or group of transactions which are repetitive and sufficiently large in number.
- Each one of the subsidiary books is a special journal and a book of original or prime entry.
- Though the usual type of journal entries are not passed in these sub-divided journals, the double entry principles of accounting are strictly followed.

- **Purchases Book** records only credit purchases of goods by the trader.
- **Sales Book** is meant for entering only credit sales of goods by the trader.
- **Purchases Return Book** records the goods returned by the trader to suppliers.
- **Sales Return Book** deals with goods returned (out of previous sales) by the customers.
- **Bills Receivable Book** records the receipts of bills (Bills Receivable).
- **Bills Payable Book** records the issue of bills (Bills Payable).
- **Cash Book** is used for recording only cash transactions i.e., receipts and payments of cash.
- **Journal Proper** is the journal which records the entries which cannot be entered in any of the above listed subsidiary books

Purchase Book

- i. Date Column – Represents the date on which the transaction took place.
- ii. Particulars Column – This column includes the name of the seller and the particulars of goods purchased.
- iii. Inward Invoice No. Column – Reveals the serial number of the inward invoice.
- iv. L.F. Column – This column shows the page number of the suppliers account in the ledger accounts.
- v. Details Column – Reveals the amount of goods purchased and the amount of trade discount.
- vi. Total Column – This column represents the net price of the goods, i.e, the amount which is payable to the creditors after adjusting discount and expenses if any.
- vii. Remarks Column – Contains any extra information.

Date	Particulars	Inward Invoice No.	L.F.	Amount Details	amount Total	Remarks

Sales Book

- Date Column – Represents the date on which the transaction took place.
- Particulars Column – This column includes the name of purchasers and the particulars of goods sold.
- Outward Invoice No. Column – Reveals the serial number of the outward invoice.
- L.F. Column – The page number of the customers accounts in the Ledger is recorded.
- Details Column – Contains the amount of goods sold and the amount of trade discount if any.
- Total Column – This column shows the net amount which is receivable from the customers.
- Remarks Column – Any other extra information will be recorded.

Date	Particulars	Outward Invoice No.	L.F.	Amount Details	amount Total	Remarks

Purchase Return Book

- This book is used to record all the goods returned to the suppliers.
- Debit note is issued to the supplier.

Date	Particulars	Debit Note No.	L.F.	Amount Details	Amount Total	Remarks

Sales Return Book

- This book is used to record all the goods returned by the customers.
- Credit note is issued to the customers.

Date	Particulars	Credit Note No.	L.F.	Amount Details	Amount Total	Remarks

Bills Receivable Book

- This book is used to record all the bills received by the business from its customers.
- It contains details regarding the name of the acceptor, date of the bill, place of payment, term of the bill, due date and the amount of the bill.

Sl. No.	Date of Receipt	L.F.	Drawer	Acceptor	Term	Due Date	Amount	Remarks

Bills Payable Book

- This book is used to record all the bills accepted by the business drawn by its creditors.
- It contains details regarding the name of the drawer, payee and date of acceptance, due date, place of payment, term and amount of the bill.

Sl. No.	Date of Acceptance	Drawer	Payee	L. F.	Where Payable	Date of Bill	Term	Due Date	Amount	Remarks

Journal Proper

- This book is used to record all the residual transactions which cannot find place in any of the subsidiary books.
- The following types of entries are passed:
 - Opening Entries
 - Closing Entries
 - Adjusting Entries
 - Transfer Entries
 - Rectifying Entries

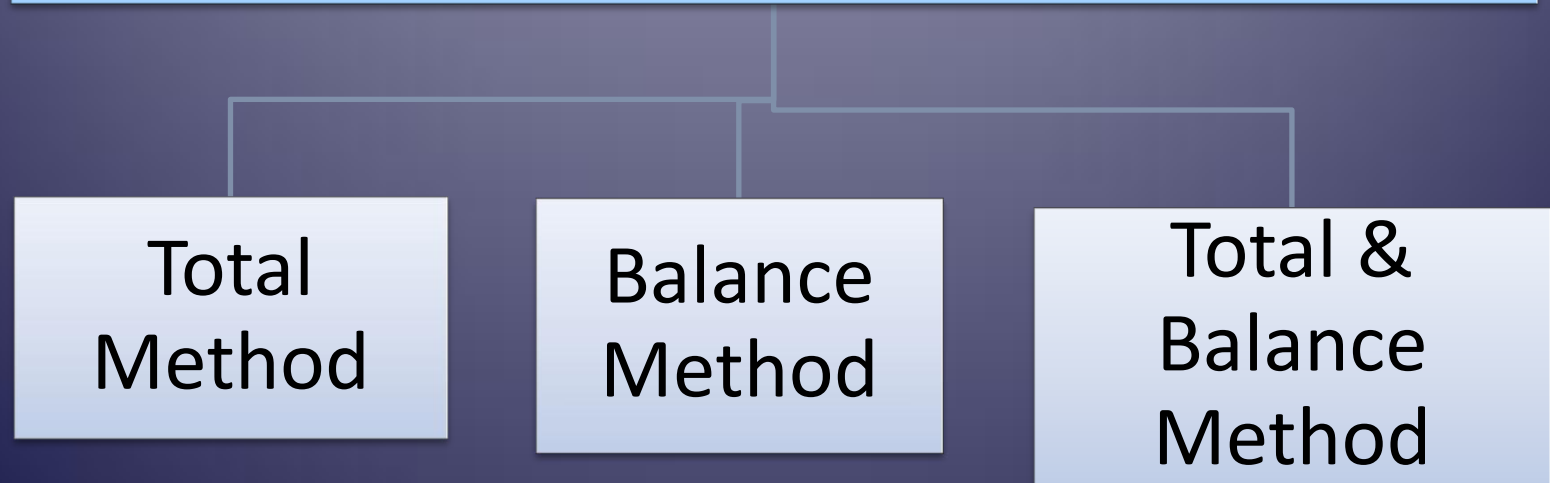
Cash Book

- A cash book is a special journal which is used to record all cash receipts and cash payments.
- The cash book is a book of original entry or prime entry since transactions are recorded for the first time from the source documents.
- The cash book is a ledger in the sense that it is designed in the form of a cash account and records cash receipts on the debit side and cash payments on the credit side. Thus, the cash book is both a journal and a ledger.
- Cash Book will always show debit balance, as cash payments can never exceed cash available.

Trial Balance

- Trial balance is a listing of all account balances that provides a test of whether total debits equals total credits. In very simple words it is prepared to check & tally if what has been spent is equal to what has been earned.
- A trial balance is a statement that shows the balances of all accounts recorded in the ledger.
- Every debit should have a corresponding credit as per the rules of the double entry system, the total of the debit and credit balances should tally.

Methods of Preparation of Trial Balance



- **Total Methods:** Under this method, the total of both sides of the account is written in Trial Balance. At last, the total of the debit side should be equal to credit side.
- **Balance Method:** under this method, the accounts are balanced first, then the amount is written in the respective side as the case may be i.e. Debit balance will be written in debit column of amount and credit balance will be written in credit column of amount. At last, total will be done and this must be equal.
- **Total & Balance Method:** The two methods are used to prepare the Trial Balance.

Example: From the following information prepare Trail Balance.

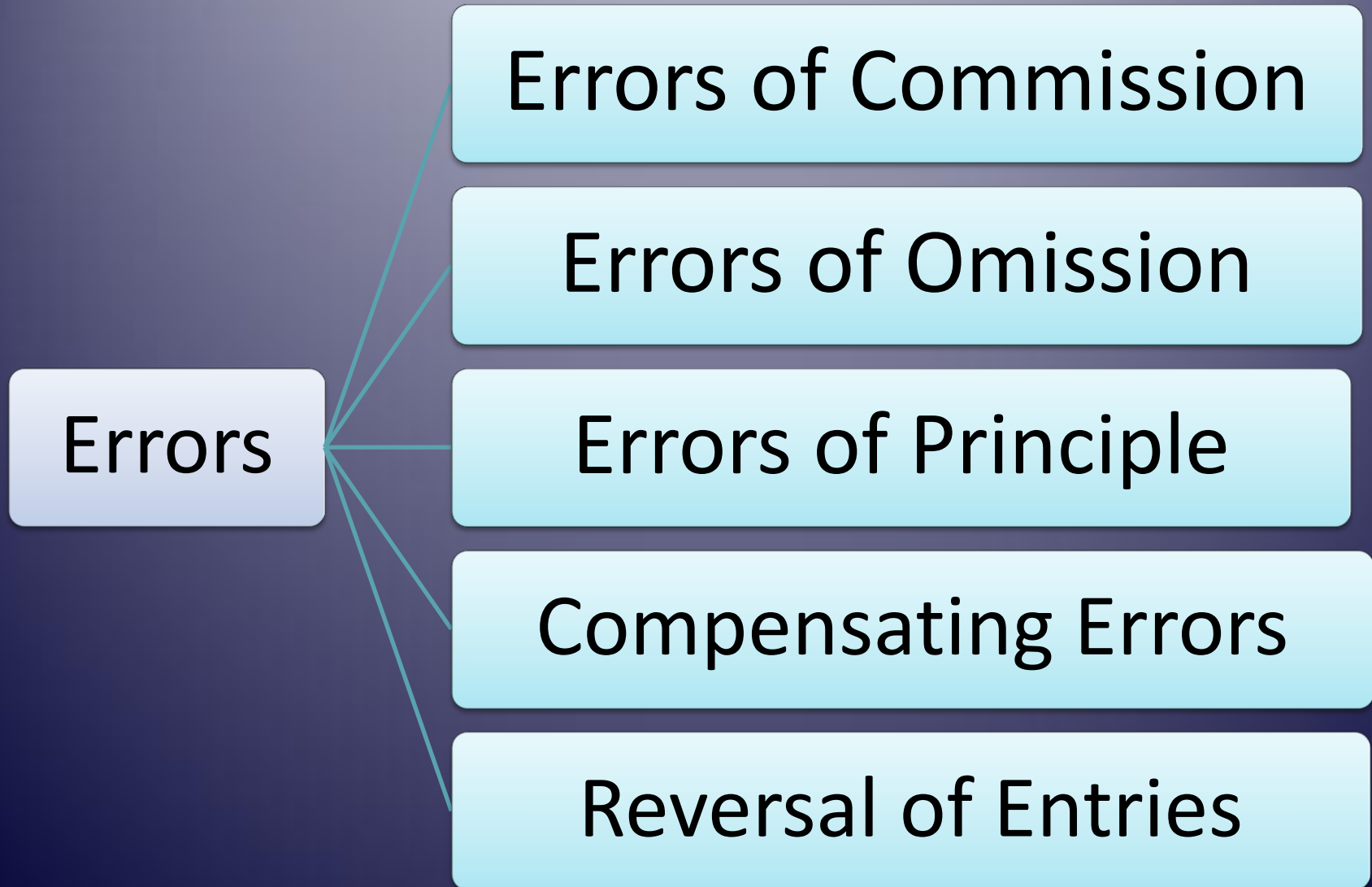
Particulars	Amount
Cash	83466
Salaries	24300
Fixed Assets	24000
Sales	293232
Purchases	221700
Accounts Receivable	48872
Stock	8000
Capital	100000
Creditors	17106
Bank loan	8000
Short term investment	8000

Solution: Trial Balance

Sl. No.	Name of the Account	Debit Amount	Credit Amount
1	Cash	83466	
2	Salaries	24300	
3	Fixed Assets	24000	
4	Sales		293232
5	Purchases	221700	
6	Accounts Receivable	48872	
7	Stock	8000	
8	Capital		100000
9	Creditors		17106
10	Bank loan		8000
11	Short term investment	8000	
	Total	418388	418388

- Errors: Sometimes while preparing the Trial Balance, trial balance does not tally, it means that there exists some errors. There are two types of errors. One is that which is not revealed by the trial balance and the other is that which is revealed by the trail balance.
- There are few errors which are exist there in spite of tallying the trial balance.

Errors which are not disclosed by Trail Balance:



- Errors of omission – transaction left out completely
- Errors of commission – correct amounts, wrong account(s)
- Errors of principle – e.g. posted a capital expense as revenue expense
- Compensating errors – errors which cancel each other out
- Reversal of entries – wrong sides of each account used

Final Account

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graph TD; A[Final Account] --- B[Trading Account]; A --- C[Profit & Loss Account]; A --- D[Balance Sheet]
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Trading
Account

Profit & Loss
Account

Balance
Sheet

Trading Account

- Trading Account is a one of the financial statement that is prepared under the Final Account.
- This is prepared to know the gross profit or gross loss earned by the business during a certain period of time.
- Gross profit/loss is calculated by matching sale proceeds and cost of goods sold.
- We can know the amount of sales and purchased and direct expenses and closing stock of that period very easily for which this is prepared.

Trading Account

For the Year Ended on.....

Particulars	Amount	Particulars	Amount
To Opening Stock	xxxxx	By Sales A/c	xxxxx
		Less: Sales return	xxx
To Purchases	xxxxx	By Closing Stock	xxxxx
Less: Purchase return	xxx		
To Direct Expenses	xxxxx	By Gross Loss c/d	xxxxx
To Gross Profit c/d	xxxxx		
	XXXXXXXX		XXXXXXXX

Profit and Loss Account

- This Account is prepared to know the amount of net profit or net loss incurred during the year/period.
- All the indirect expenses and indirect incomes are considered while preparing this account.
- Various provisions are made in this very Account.
- The Balance of this account is transferred to Capital Account in the Balance Sheet.

Profit & Loss Account

For the Year Ended on 31st March.....

Particulars	Amount	Particulars	Amount
To Gross Loss b/d	xxxxx	By Gross Profit b/d	xxxxx
To Administrative Exp.	xxxxx	By Discount Receives	xxxxx
To Selling Expenses	xxxxx	By Commission Received	xxxxx
To Distribution Exp.	xxxxx	by Net Loss	xxxxx
To Net Profit	xxxxx		
	xxxxxxx		xxxxxxx

Balance Sheet

- This is a statement not an Account.
- All the liabilities , capital and assets are shown in this statement.
- This statement shows the financial position of the business.
- This shows the financial position of the business of that date on which it is prepared.
- The liabilities side must be equal to assets side as it is prepared on the basis of double entry system.

Balance Sheet

As on 31st March.....

Liabilities		Amount	Assets	
Capital	xxxxx	xxxxxxx	Fixed Assets	xxxxx
Add: Net Profit	xxxx			
Less: Drawing	xxxx			
General Reserve		xxxxx	investments	xxxxx
Long term Loans		xxxxx	Current Assets	xxxxx
Creditors		xxxxx	Miscellaneous Expenditure	xxxxx
Short term Loans		xxxxx		
Bills Payable		xxxxx		
		xxxxxx		xxxxxx

Depreciation

- Depreciation is the reduction in the value of fixed asset due to its use, wear and tear or obsolescence. When an asset is used for earning purposes, it is necessary that reduction due to its use must be charged to the Profit and Loss account of that year in order to show correct profit or loss and to show the asset at its correct value in the Balance Sheet.
- According to IAS-4, “Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life,”
- According to AS-6, “depreciation is a measure of wearing out, consumption or other of value of a depreciable asset arising from use, effusion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the assets. Depreciation includes amortisation of assets whose useful life is pre determined.”

According to the Institute of Chartered Accountant of India, "Depreciation is the measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes.

Causes of Depreciation

- Continuous use of assets
- Time factor
- Exhaustion
- Obsolescence
- Accidents
- Decreasing market value of assets

Need of charging Depreciation

- To calculate the true Profit or Loss of the business
- To show the true and fair financial position
- Showing fixed assets at its market value
- For replacing assets
- For tax reasons

Straight Line Method

- Depreciation is charged for every year will be the constant amount throughout the life of the asset.
- Depreciation is calculated by deducting the scrap value from the original cost of an asset and the balance is divided by the number of years estimated as the life of the asset.

$$\text{Depreciation} = \frac{\text{Original Cost of Asset} - \text{Scrap Value}}{\text{Estimated Life of the Asset}}$$

- When neither scrap value nor estimated life is given, then the following formula will be applied to calculate the depreciation under straight line method of depreciation:

Depreciation =

Original cost of the Asset * Rate of depreciation

100

- This calculated depreciation amount will be charged over the years.

Written Down Value Method

- Under this method depreciation is charged at fixed rate on the reducing balance every year.
- The amount of depreciation gradually reducing every year.
- The depreciation charge in the initial period is high depreciation charge in the initial period is high and negligible amount in the later period of the asset.

- The following formula can be applied to calculate the rate of depreciation under diminishing balance method of depreciation.

$$\text{Depreciation Rate} = 1 - \sqrt[n]{s/c} * 100$$

Where,

s = Estimated Scrap Value of Asset

c = Original Cost of the Asset

n = Estimated life of Asset

Example:

An asset is purchased for Rs. 150000 and it will have a residual value of Rs. 30000. The estimated useful life of asset is 12 years. Calculate the amount of annual depreciation under straight line method.

Answer:

$$\begin{aligned} \text{Depreciation} &= \frac{\text{Original Cost of Asset} - \text{Scrap Value}}{\text{Estimated Life of the Asset}} \\ &= \frac{150000 - 30000}{12} \\ &= 10000 \text{ Rs.} \end{aligned}$$

Example:

A machinery is purchased for Rs. 50000 and Rs. 10000 is paid for its installation on 1st Jan. 2012. The scrap value of machinery is Rs. 6000 and its estimated life is 3 years. Prepare machinery account for three years.

Solution:

$$\text{Depreciation} = \frac{(50000 + 10000) - 6000}{3} = \text{Rs. } 18000$$

Machinery Account

Date	Particulars	Amount	Date	Particulars	Amount
2012 Jan. 1	To Cash A/c	60000	Dec. 31	By Depreciation A/c	18000
			Dec. 31	By Balance c/d	42000
		60000			60000
2013 Jan. 1	To Balance b/d	42000	Dec. 31	By Depreciation A/c	18000
			Dec. 31	By Balance c/d	24000
		42000			42000
2014 Jan. 1	To Balance b/d	24000	Dec. 31	By Depreciation A/c	18000
			Dec. 31	By Balance c/d	6000
		24000			24000

Example:

XYZ Co. has purchased a truck for Rs. 100000 on 1st January, 2010 for business purpose. The rate of depreciation is 20 percent per year. Depreciation is charged on written down value method. Prepare Truck Account for the first three years.

Truck Account

Date	Particulars	Amount	Date	Particulars	Amount
2010 Jan. 1	To Cash A/c	100000	Dec. 31	By Depreciation A/c	22000
			Dec. 31	By Balance c/d	80000
		100000			100000
2011 Jan. 1	To Balance b/d	80000	Dec. 31	By Depreciation A/c	16000
			Dec. 31	By Balance c/d	64000
		80000			80000
2012 Jan. 1	To Balance b/d	64000	Dec. 31	By Depreciation A/c	12800
			Dec. 31	By Balance c/d	51200
		64000			64000

Provision

- Provision is an amount set aside to provide for known liability the amount which cannot be determined accurately.
- This is charge against Profit & Loss Account
- It is shown in the Assets side of the balance sheet by deducting from concerned asset.
- It is also shown on the liabilities side of the balance sheet under the head “Current Liabilities and Provisions”
- For example, Provision for Depreciation, Provision for Bad and doubtful debts, Provision for Taxation etc.

Reserve

- Reserves are the amount set aside out of profits.
- It is an appropriation of profits to strengthen the financial position of the business.
- According to R. G. Williams, “Reserve is the amount set aside out of undivided profits and other surpluses in order to strengthen the financial position of the business, but not designed to meet any liability or contingency known to exist at the date of Balance Sheet.”
- This is shown in the Balance Sheet on Liabilities side under the head “Reserve & Surplus”.

Types of reserves

- **General reserve** – It is the amount set aside out of profits for no specific purpose. It is available for strengthen the financial position or expansion of business.
- **Specific reserve** – This is created for specific purpose and can be utilized only for that purpose.
- **Secret reserve** – It is a reserve the existence or the amount of which is not disclosed in the balance sheet. It is also known as hidden reserve.

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