The McGraw-Hill Companies

ACCOUNTING MADE EASY

Second Edition

About the Authors

Rajesh Agrawal

Rajesh Agrawal is the Director of Finance at the International Crops Research Institute for the Semi Arid Tropics (ICRISAT), Hyderabad, a leading United Nations research organization. He is a graduate in commerce from St. Xavier's College, Kolkata and a chartered accountant and cost accountant. He was a faculty member in the Finance & Accounting area at the Indian Institute of Management, Ahmedabad [IIMA] for a five year period starting 1997. He was the Chairman of the Finance & Accounting area at IIMA during the period 1999-2000. Before joining the faculty at IIMA, he was a faculty member at Institute of Rural Management, Anand for over six years.

His areas of specialisation and research are financial accounting and financial reporting, strategic cost management and management control systems. He has been a consultant to the industry, government, non-governmental organisations and Food and Agricultural Organisation of the United Nations.

R Srinivasan

R Srinivasan is Professor, Finance & Control area at the Indian Institute of Management, Bangalore (IIMB). Earlier, he was Dean (Academic) and the Chairperson of the Finance & Control area at IIMB. His areas of interest are corporate finance, project management, management control and microfinance.

He has an M.Sc. in Physics from the Indian Institute of Technology, Bombay, and a post-graduate diploma in management & Fellow title (doctorate) from the Indian Institute of Management, Ahmedabad.

He was previously a member of the faculty at the Institute of Rural Management, Anand. He has also worked with a commercial bank, and with an engineering & construction company. His consulting experience covers international organisations, the corporate and the development sectors.

The McGraw·Hill Companies

ACCOUNTING MADE EASY

Second Edition

Rajesh Agrawal
Director of Finance,
International Crops Research Institute
for the Semi Arid Tropics, Hyderabad
(Formerly Associate Professor,
Indian Institute of Management, Ahmedabad)

R Srinivasan
Professor, Finance & Control area
Indian Institute of Management, Bangalore

Tata McGraw Hill Education Private Limited
NEW DELHI

McGraw-Hill Offices
New Delhi New York St Louis San Francisco Auckland Bogotá Caracas Kuala Lumpur Lisbon London Madrid Mexico City Milan Montreal San Juan Santiago Singapore Sydney Tokyo Toronto

The McGraw·Hill Companies

Tata McGraw-Hill

Published by the Tata McGraw Hill Education Private Limited,
7 West Patel Nagar, New Delhi 110 008.

Accounting Made Easy, 2/e

ISBN-13: 978-0-07-070098-7
ISBN-10: 0-07-070098-7

Managing Director: *Ajay Shukla*
Head—Higher Education Publishing and Marketing: *Vibha Mahajan*
Publishing Manager—B&E/HSSL: *Tapas K Maji*
Deputy Manager (Sponsoring): *Surabhi Khare*
Development Editor: *Shalini Negi*
Assistant Manager (Editorial Services): *Anubha Srivastava*
Senior Copy Editor: *Sneha Kumari*
Senior Production Manager: *Manohar Lal*
Production Executive: *Atul Gupta*
Deputy Marketing Manager: *Vijay S Jagannathan*
Senior Product Specialist: *Daisy Sachdeva*
General Manager—Production: *Rajender P Ghansela*
Assistant General Manager—Production: *B L Dogra*

Typeset at The Composers, 260, C.A. Apt., Paschim Vihar, New Delhi 110 063 and printed at
Sai Printo Pack, A-102/4, Okhla Industrial Area, Phase-II, New Delhi 110 020

Cover Design: K Anoop

Cover Printer: Sai Printo Pack

RALQCRQZRZRQB

The McGraw·Hill Companies

Dedicated to
the anonymous victims of
debits
and
credits

Preface

The ex-WorldCom CEO, under trial for a US $11 billion accounting fraud, defended himself thus: "I don't know about finance and accounting." What he studied was physical education in college.

Now, while the importance of physical education cannot be overemphasised, this book is for those who wish to learn financial accounting. If you are not sure, take this quick quiz—would you rather be followed by a knife-wielding maniac in a dark alley on a moonless night or by a kindly accountant in broad daylight explaining why your six-figure salary job produces a monthly pay cheque of Rs. 421.44?

Financial accounting broadly deals with how financial transactions within an organisation are accounted for and how financial statements are prepared. Even well-written books on this subject tend to be scary. This is because formal accounting is taught through two brain-mangling concepts: 'debit' and 'credit'.

This book is intended to provide a simple and easy-to-assimilate introduction to the subject. It is built around two levels. Level-1 (you will not believe this but it's true) does not use either of the no-no words till the last page. You will learn basic financial accounting without being traumatised, much like our enterprising hero Ramaswamy (in this book) learns it from his trusted accountant, Munimji. Level-2 does introduce both these words and teaches you formal accounting. The book uses a set of self-learning exercises. Level-2 uses the same illustrations as Level-1, so that your conceptual foundations are strengthened.

This is a preparatory workbook for those who intend to study accounting formally (such as students of MBA programmes, chartered financial analysts program, chartered accountancy, cost accountancy, company secretaryship, banking, B Com or BBA). It will also be of use to those who wish to have a basic and clear understanding of financial accounting. If you are a manager in a company, this may be the right book to understand enough accounting to deal with your organisation's daily life. By the time you have finished this book, the core logic of financial accounting should be clear.

A final word on the origin of this book. We have had, through our years of teaching, a series of students who kept asking to be taught accounting. However, when we asked them to work on an accounting book, they would say, "You work, we'll watch". It gives us great pleasure to be able to say—this time, *you* work, we'll watch.

Learn accounting basics, by yourself, quickly, and in style.

RAJESH AGRAWAL
R SRINIVASAN

The McGraw-Hill Companies

DO NOT WORRY IF

- you do not get the solutions right in the initial exercises.
- you use an account head and find the book uses another. Accounting does not have a standardised vocabulary. The book uses, for instance, the term *creditors*. You may have used the term *payables*. Chapter seven lists several such commonly used terms and their variants.
- your items are not in the same order as in the solution provided. For the purpose of basic accounting the order is relatively unimportant. The order is important in presentation of financial statements. The explanation for the order is deliberately provided only in chapter seven.
- you find the exercises a little unrealistic. You may disagree with the amount of cloth or the labour required to produce a pair of trousers. Never mind—the purpose of the book is to teach accounting.
- you get everything wrong. Life probably has bigger troubles in store for you!

Contents

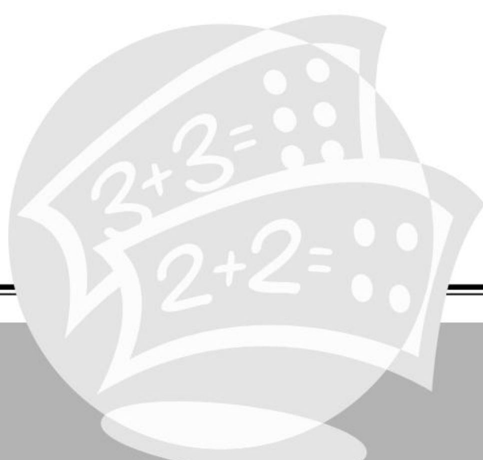
The McGraw-Hill Companies

Accounting Made Easy

Level 1

2

1



HOW TO USE LEVEL—1

Exercise Features

Level-1 has six self-contained exercises which should be done in the given order. Each exercise refers to a specific company.

Each exercise:

- adds a few new concepts to those introduced in earlier exercises. If these are done in the order they are presented, the transition from one exercise to the next will be smooth
- has a 'solution sheet' provided at the end
- consists of several transactions

Each transaction has:

- a description of a monetary transaction, usually with a hint when there is a possibility of confusion
- a solution to the transaction on the following page
- an explanation for the solution

Item-heads [account-heads] in the exercises are italicized.

Usage

The user is expected to:

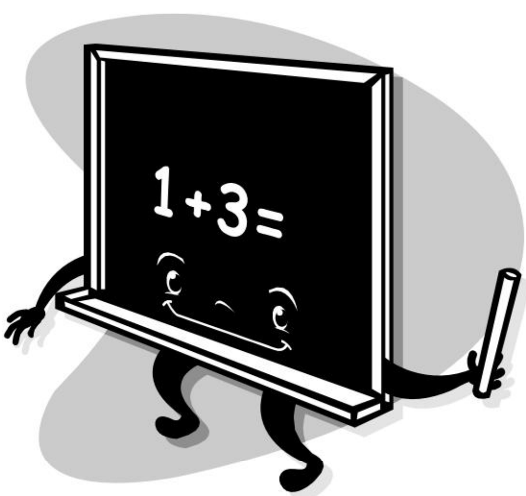
- read the transaction description
- fill up the solution sheet with a pencil
- check with the solution and the explanation provided
- proceed to the next transaction

The McGraw-Hill Companies

CHAPTER 1

The Green Company (Cash and Trading)

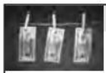
APRIL



THE BEGINNING

When Ramaswamy retired, bringing home a grand sum of Rs. 218,442 plus a pension, he surprised his friends by announcing that he was starting a business.

"You do not know how to buy," said some. "You do not know how to sell," said others. "You are a traitor," said his colleagues, "Remember that not a single industrial licence was approved by your section for thirty years." "Never mind," replied Ramaswamy, "I will learn to buy and sell and with my trusted accountant Munimji's help, I'll even learn to account. As for ideas, I have 2483 industrial licence applications stacked up at home."



Transaction 1

On April 1, Ramaswamy withdrew Rs. 100,000 from his bank and announced the formation of the Green Company with this amount as the initial capital.

"You can prepare a balance sheet after this transaction," said Munimji. "Show what the Green Company *owns* on the asset side and what it *owes* as a liability. Remember that a balance sheet is not like the government budget. It actually balances, and assets should equal liabilities."

Fill up the Green Solution Sheet (at the end of this chapter) after this transaction.

Hint: What is the SINGLE asset of the Green Company?
What is the SINGLE liability?

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Green Company as of 1st April

ITEM	OPENING BALANCE SHEET	TRANSACTION 1		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Cash	0	+	100,000	100,000
TOTAL ASSETS				100,000
LIABILITIES [OWED]				
Capital	0	+	100,000	100,000
TOTAL LIABILITIES				100,000

Explanation for Transaction 1

Cash The Green Company *owns* Rs. 100,000 cash, hopefully lying safely in its cash box. This cash is the SINGLE asset of Green Company.

Capital The Green Company *owes* Ramaswamy Rs. 100,000. This is the capital he invested in the Company.

Notice that the Green Company and Ramaswamy are treated as two different and separate entities. Therefore, it is the Green Company which *owns* the cash of Rs. 100,000. Again, it is the company which is liable to pay Ramaswamy the capital of Rs. 100,000 provided by him.

Hopefully, Mrs Ramaswamy will also respect this difference and take money, when she needs it, from Ramaswamy and not from the company.

Transaction 2

Just when Ramaswamy was about to start trading, he was told that he was being terribly old-fashioned. How could he run a business without a bank loan? So on April 2, Ramaswamy went to the bank feeling a little nervous. But the bank manager recognized him. "You are Licence Ramaswamy. The nation is proud of you. But for you, our bank would have lost a few thousand crores in bad loans. Well, if you want only Rs. 50,000, here it is in cash. Our door is always open if you want more."

Fill up the Green Solution Sheet after this transaction.

Hint: What is the NEW liability item?

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Green Company as of 2nd April

ITEM	OPENING BALANCE SHEET	TRANSACTION 2		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Cash	100,000	+	50,000	150,000
TOTAL ASSETS	100,000			150,000
LIABILITIES [OWED]				
Capital	100,000			100,000
Bank Loan	0	+	50,000	50,000
TOTAL LIABILITIES	100,000			150,000

Explanation for Transaction 2

Cash — The bank loan has added Rs. 50,000 to the Green Company's previous cash balance of Rs. 100,000. The SINGLE asset that the Green Company *owns* is this cash balance of Rs. 150,000.

Bank Loan — The Green Company *owes* the bank Rs. 50,000. This bank loan is the NEW liability item. This is in addition to the Rs. 100,000 *owed* to Ramaswamy representing the original capital supplied by him.

Transaction 3

On April 3, Ramaswamy bought a small shop building for Rs. 25,000, paying cash to the pleasant surprise of the seller. His old friends in the municipality helped him to register the building purchase quickly, in the Green Company's name.

Fill up the Green Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Green Company as of 3rd April

ITEM	OPENING BALANCE SHEET	TRANSACTION 3		**CLOSING BALANCE SHEET**
ASSETS [OWNED]				
Building	0	+	25,000	25,000
Cash	150,000	—	25,000	125,000
TOTAL ASSETS	150,000			150,000
LIABILITIES [OWED]				
Capital	100,000			100,000
Bank Loan	50,000			50,000
TOTAL LIABILITIES	150,000			150,000

Explanation for Transaction 3

Cash The cash balance has been reduced by Rs. 25,000, the sum paid to the seller of the building.

Building The Green Company is now the proud owner of a NEW asset—the shop building.

Notice that the total assets of the Green Company remain unchanged at Rs. 150,000 from the previous transaction. The composition of assets has changed from *cash* alone to *cash* and *building*.

These assets of Rs. 150,000 are financed by the initial *capital* of Rs. 100,000 and a *bank loan* of Rs. 50,000.

Transaction 4

Given his lack of experience, Ramaswamy decided to make a small start. On April 4, he bought Rs. 10,000 worth of sugar—as usual paying cash.

Fill up the Green Solution Sheet after this transaction.

Hint: What is the NEW asset item?

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Green Company as of 4th April

ITEM	OPENING BALANCE SHEET	TRANSACTION 4		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Building	25,000			25,000
Stocks	0	+	10,000	10,000
Cash	125,000	—	10,000	115,000
TOTAL ASSETS	150,000			150,000
LIABILITIES [OWED]				
Capital	100,000			100,000
Bank Loan	50,000			50,000
TOTAL LIABILITIES	150,000			150,000

Explanation for Transaction 4

Cash The cash balance has decreased by Rs. 10,000, the sum paid to the seller of the sugar.

Stocks The NEW asset is the stock of sugar.

This transaction resembles the previous one. The NEW asset now is the stock of sugar instead of the shop building.

Transaction 5

Fortune favoured Ramaswamy. On 4th evening, the government decontrolled sugar. Ramaswamy promptly sold his entire stock of sugar on April 5, for Rs. 12,000, for cash.

Fill up the Green Solution Sheet after this transaction.

Hint: What asset item has VANISHED? What is the NEW liability item?

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Green Company as of 5th April

ITEM	OPENING BALANCE SHEET	TRANSACTION 5		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Building	25,000			25,000
Stocks	10,000	—	10,000	0
Cash	115,000	+	12,000	127,000
TOTAL ASSETS	150,000			152,000
LIABILITIES [OWED]				
Capital	100,000			100,000
Retained Earnings	0	+	2,000	2,000
Bank Loan	50,000			50,000
TOTAL LIABILITIES	150,000			152,000

Explanation for Transaction 5

Cash The cash balance has increased by Rs. 12,000, paid by the buyer of the sugar.

Stocks The company now does not *own* any stocks, since the entire stock was sold.

Retained Earnings Now comes a tricky item. The Green Company made a profit of Rs. 2,000 on the sugar deal [Rs. 12,000 minus Rs. 10,000]. The income statement for April is provided below. This profit earned by the Green Company belongs to the suppliers of capital—in this case Ramaswamy alone. Hence, the Company *owes* Ramaswamy an additional Rs. 2,000 over and above the Rs. 100,000 *owed* earlier. This Rs. 2,000 is called *retained earnings* since the earnings are retained with the Green Company and have not yet been paid out to the suppliers of capital.

Income Statement of the Green Company
for the Period April 1 to April 5

	Rupees
Sales	12,000
Expenses:	
Material	10,000
Profits	2,000

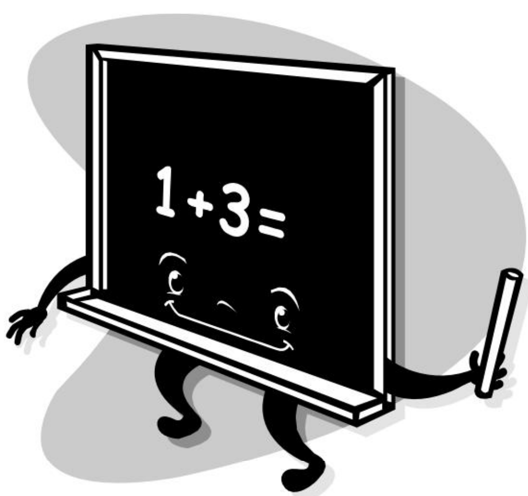
The Green Company has sold for Rs. 12,000, the material purchased for Rs. 10,000. This difference of Rs. 2,000 is the profit for the month of April.

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

CHAPTER 2

The Yellow Company (Credit and Trading)

MAY



THE BEGINNING

Ramaswamy took the rest of April off, to celebrate the success of his maiden business venture.

On May 1, he started the Yellow Company. “Credit is the key to big business,” he declared.

Transaction 1

Ramaswamy put in Rs. 50,000 cash as capital and persuaded his wife to give an interest-free cash loan of Rs. 75,000.

Fill up the Yellow Solution Sheet after this transaction.

Hint: Remember the Green Company!

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Yellow Company as of 1st May

ITEM	OPENING BALANCE SHEET	TRANSACTION 1		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Cash	0	+	125,000	125,000
TOTAL ASSETS				125,000
LIABILITIES [OWED]				
Capital	0	+	50,000	50,000
Loan–Mrs. Ramaswamy	0	+	75,000	75,000
TOTAL LIABILITIES				125,000

Explanation for Transaction 1

Cash	The cash balance represents Rs. 50,000 received from Ramaswamy and Rs. 75,000 from his wife.
Capital	The Yellow Company *owes* Rs. 50,000 to Ramaswamy who supplied the initial capital.
Loan—Mrs. Ramaswamy	The Yellow Company *owes* Rs. 75,000 to Mrs. Ramaswamy.

Transaction 2

On May 3, the Yellow Company bought office furniture for Rs. 10,000, paying cash.

Fill up the Yellow Solution Sheet after this transaction.

Hint: What is the NEW asset the Yellow Company *owns*?

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Yellow Company as of 3rd May

ITEM	OPENING BALANCE SHEET	TRANSACTION 2		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Furniture	0	+	10,000	10,000
Cash	125,000	—	10,000	115,000
TOTAL ASSETS	125,000			125,000
LIABILITIES [OWED]				
Capital	50,000			50,000
Loan–Mrs. Ramaswamy	75,000			75,000
TOTAL LIABILITIES	125,000			125,000

Explanation for Transaction 2

Cash The cash balance has reduced by Rs. 10,000, the sum paid to the furniture supplier.

Furniture The NEW asset is the furniture bought.

Transaction 3

On May 10, Ramaswamy bought Rs. 50,000 worth of cement on credit, agreeing to pay the seller in two weeks.

Fill up the Yellow Solution Sheet after this transaction.

Hint: What is the NEW asset? To WHOM does the Yellow Company now *owe* money, apart from the Ramaswamys?

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Yellow Company as of 10th May

ITEM	OPENING BALANCE SHEET	TRANSACTION 3		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Furniture	10,000			10,000
Stocks	0	+	50,000	50,000
Cash	115,000			115,000
TOTAL ASSETS	125,000			175,000
LIABILITIES [OWED]				
Capital	50,000			50,000
Loan–Mrs. Ramaswamy	75,000			75,000
Creditors	0	+	50,000	50,000
TOTAL LIABILITIES	125,000			175,000

Explanation for Transaction 3

Stocks The Yellow Company now has stocks of cement worth Rs. 50,000.

Creditors The cement purchase has, so far, not been paid for. The Yellow Company *owes* the supplier Rs. 50,000. The supplier is a creditor to the company having extended the two-week credit.

Transaction 4

Ramaswamy's luck still held. Cement prices went up sharply, and he sold his entire stock on May 15, for Rs. 60,000. The buyer promised to pay in a week.

Fill up the Yellow Solution Sheet after this transaction.

Hint: Like the Green Company, the Yellow Company has made a profit by trading. However, cash is yet to be received from the buyer. What is the NEW asset and the NEW liability?

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Yellow Company as of 15th May

ITEM	OPENING BALANCE SHEET	TRANSACTION 4		**CLOSING BALANCE SHEET**
ASSETS [OWNED]				
Furniture	10,000			10,000
Stocks	50,000	—	50,000	0
Debtors	0	+	60,000	60,000
Cash	115,000			115,000
TOTAL ASSETS	175,000			185,000
LIABILITIES [OWED]				
Capital	50,000			50,000
Retained Earnings	0	+	10,000	10,000
Loan–Mrs. Ramaswamy	75,000			75,000
Creditors	50,000			50,000
TOTAL LIABILITIES	175,000			185,000

Explanation for Transaction 4

Stocks — The entire stock of cement has been sold—The Yellow Company now has no stocks.

Debtors — The Yellow Company *owns* a claim of Rs. 60,000 on the cement purchaser. This buyer is indebted to the company, till he pays for the cement.

Retained Earnings — The company has made a profit of Rs. 10,000 on this deal, which has been retained by the company.

The income statement is at the end of this exercise.

Transaction 5

The cement purchaser turned out to be reliable, and paid Rs. 60,000 promptly on May 22. Ramaswamy, who had been quite nervous, heaved a sigh of relief.

Fill up the Yellow Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Yellow Company as of 22nd May

ITEM	OPENING BALANCE SHEET	TRANSACTION 5		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Furniture	10,000			10,000
Stocks				
Debtors	60,000	—	60,000	0
Cash	115,000	+	60,000	175,000
TOTAL ASSETS	185,000			185,000
LIABILITIES [OWED]				
Capital	50,000			50,000
Retained Earnings	10,000			10,000
Loan–Mrs. Ramaswamy	75,000			75,000
Creditors	50,000			50,000
TOTAL LIABILITIES	185,000			185,000

Explanation for Transaction 5

Debtors The purchaser has paid up fully, and the Yellow Company does not *own* any claim on the purchaser.

Cash The money paid by the purchaser has increased the cash balance by Rs. 60,000.

Transaction 6

Ramaswamy, under pressure to keep his word now that his debtor had done so, paid the amount due to the cement supplier on May 23.

Fill up the Yellow Solution Sheet after this transaction.

Hint: This transaction is the mirror image of the previous one.

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Yellow Company as of 23rd May

ITEM	OPENING BALANCE SHEET	TRANSACTION 6		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Furniture	10,000			10,000
Stocks				
Debtors				
Cash	175,000	—	50,000	125,000
TOTAL ASSETS	185,000			135,000
LIABILITIES [OWED]				
Capital	50,000			50,000
Retained Earnings	10,000			10,000
Loan–Mrs. Ramaswamy	75,000			75,000
Creditors	50,000	—	50,000	0
TOTAL LIABILITIES	185,000			135,000

Explanation for Transaction 6

Cash	Rs. 50,000 cash has been used to settle the creditor.
Creditors	The Yellow Company no longer *owes* any money for the cement purchase.

Transaction 7

"What about me?" said Mrs. Ramaswamy, "Now that you are a lakhpathi, how about repaying my loan!" Ramaswamy after much thought paid Rs. 25,000 on May 31. "If I pay the entire loan people will think I am a sucker."

Fill up the Yellow Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Yellow Company as of 31st May

ITEM	OPENING BALANCE SHEET	TRANSACTION 7		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Furniture	10,000			10,000
Stocks				
Debtors				
Cash	125,000	—	25,000	100,000
TOTAL ASSETS	135,000			110,000
LIABILITIES [OWED]				
Capital	50,000			50,000
Retained Earnings	10,000			10,000
Loan–Mrs. Ramaswamy	75,000	—	25,000	50,000
Creditors				
TOTAL LIABILITIES	135,000			110,000

Explanation for Transaction 7

Cash	The cash balance has been further reduced by Rs. 25,000, the sum paid by the Yellow Company to Mrs. Ramaswamy.
Loan—Mrs. Ramaswamy	The Yellow Company now *owes* Mrs. Ramaswamy only Rs. 50,000.

Income Statement of the Yellow Company for the Period May 1 to May 31

	Rupees
Sales	60,000
Expenses:	
Material	50,000
Profits	10,000

The Yellow Company has sold for Rs. 60,000, the material purchased for Rs. 50,000. This difference of Rs. 10,000 is the profit for the month of May.

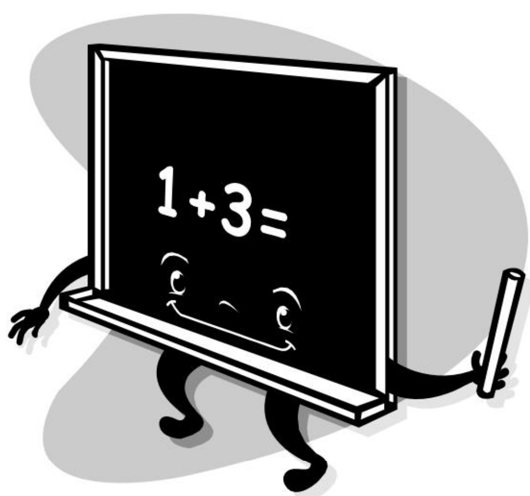
Profits are recognized when sales are made. Once the sales are made, the timing of cash receipt is immaterial. Even if the company had not received Rs. 60,000 by May-end, the profits would have remained Rs. 10,000.

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

CHAPTER 3

The Blue Company (Credit and Manufacturing)

JULY



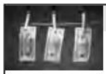
THE BEGINNING

Flush with confidence, Ramaswamy decided to start manufacturing. He rejected all the ideas in his collection of industrial licence applications as being too complicated.

Instead, he decided to start a simple garment manufacturing unit.

Several of his friends suspected that Ramaswamy would become a tycoon and kept pestering him to accept some capital from them.

"All right," said Ramaswamy, "but I am going to have the majority holding. You people stay off."



Transaction I

On July 1, Ramaswamy started the Blue Company with Rs. 100,001 of his own and Rs. 99,999 provided by his friends. His banker fell on his knees and pleaded with Ramaswamy to honour him by taking a loan of Rs. 300,000. Ramaswamy agreed and had the cash delivered.

Fill up the Blue Solution Sheet after this transaction.

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Blue Company as of 1st July

ITEM	OPENING BALANCE SHEET	TRANSACTION 1		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Cash	0	+	500,000	500,000
TOTAL ASSETS				500,000
LIABILITIES [OWED]				
Capital	0	+	200,000	200,000
Bank Loan	0	+	300,000	300,000
TOTAL LIABILITIES				500,000

Explanation for Transaction 1

Cash	The cash balance of the Blue Company is Rs. 500,000; Rs. 200,000 from Ramaswamy and his friends, and Rs. 300,000 from the bank.
Capital	The Blue Company has a total capital of Rs. 200,000. Of this Rs. 100,001 is *owed* to Ramaswamy, and Rs. 99,999 *owed* to his friends.
Bank loan	The Company *owes* the bank Rs. 300,000.

Transaction 2

Before commencing manufacture, the Blue Company needed some fixed assets—a building, equipment and some furniture. On July 3, Ramaswamy purchased a building for Rs. 50,000, the required equipment for Rs. 200,000, and furniture for Rs. 20,000, including an executive chair. Ramaswamy swivelled on his new chair, handing over cash to all the sellers.

fill

Fill up the Blue Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Blue Company as of 3rd July

ITEM	OPENING BALANCE SHEET	TRANSACTION 2		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Building	0	+	50,000	50,000
Equipment	0	+	200,000	200,000
Furniture	0	+	20,000	20,000
Cash	500,000	—	270,000	230,000
TOTAL ASSETS	500,000			500,000
LIABILITIES [OWED]				
Capital	200,000			200,000
Bank Loan	300,000			300,000
TOTAL LIABILITIES	500,000			500,000

Explanation for Transaction 2

Building *Equipment* *Furniture*	The Blue Company now *owns* these three types of fixed assets, and can commence manufacturing.
Cash	The company, having paid out Rs. 270,000 for acquiring the fixed assets, now *owns* that much less cash.

Transaction 3

Ramaswamy obtained a contract for supply of 1,000 pairs of denim jeans to the Ministry of Commerce, who were in the process of globalisation, at Rs. 250 per pair of jeans.

On July 7, the Blue Company purchased 2000 metres of cloth at Rs. 50 per metre, promising to pay by the end of the month.

Fill up the Blue Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Blue Company as of 7th July

ITEM	OPENING BALANCE SHEET	TRANSACTION 3		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Building	50,000			50,000
Equipment	200,000			200,000
Furniture	20,000			20,000
Stocks–Raw Mat.	0	+	100,000	100,000
Cash	230,000			230,000
TOTAL ASSETS	500,000			600,000

ITEM	OPENING BALANCE SHEET	TRANSACTION 3		CLOSING BALANCE SHEET
LIABILITIES [OWED]				
Capital	200,000			200,000
Bank Loan	300,000			300,000
Creditors	0	+	100,000	100,000
TOTAL LIABILITIES	500,000			600,000

Explanation for Transaction 3

Stocks–Raw Mat. The Blue Company now *owns* 2,000 metres of cloth worth Rs. 100,000 which is the raw material for the jeans.

As manufacturing takes place, the raw material is converted first into partly completed jeans, and finally into saleable jeans.

Creditors The company now *owes* Rs. 100,000 to the cloth supplier.

Transaction 4

Ramaswamy hired a team of workers who agreed to do the entire job for Rs. 80,000 payable at the end of the month. By July 15, the workers had completed about half the job. The entire cloth had been cut. Ramaswamy was a distinctly worried man; he hoped that jeans would finally emerge from the mess.

Fill

Fill up the Blue Solution Sheet after this transaction.

Hint: Obviously the Blue Company has neither raw material, nor finished jeans. What it has are incomplete jeans. Apart from the cloth value, these incomplete jeans have some labour expended on them—about Rs. 40,000 worth.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Blue Company as of 15th July

ITEM	OPENING BALANCE SHEET	TRANSACTION 4		**CLOSING BALANCE SHEET**
ASSETS [OWNED]				
Building	50,000			50,000
Equipment	200,000			200,000
Furniture	20,000			20,000
Stocks–Raw Mat.	100,000	—	100,000	0
Stocks-WIP	0	+	140,000	140,000
Cash	230,000			230,000
TOTAL ASSETS	600,000			640,000
LIABILITIES [OWED]				
Capital	200,000			200,000
Bank Loan	300,000			300,000
Creditors	100,000			100,000
Accrued Wages	0	+	40,000	40,000
TOTAL LIABILITIES	600,000			640,000

Explanation for Transaction 4

Stocks—Raw Mat. The stock of raw material has been converted into partly completed jeans, and hence is no longer treated as raw material in the accounts.

Stocks—WIP The Blue Company now *owns* WIP [work-in-progress]. This WIP is not just raw material cut to pieces, but has had labour expended on it. Assuming that half the total labour of Rs. 80,000 has been expended, the WIP is worth Rs. 140,000 [Rs. 100,000 of raw material and Rs. 40,000 of labour].

Accrued Wages The company had promised to pay Rs. 80,000 to the workers, at the end of the month. Therefore, no money is legally due to them as on July 15.

However, the company has obtained work worth Rs. 40,000 from the workers, the value reflected in the WIP. Corresponding to this value, the company shows Rs. 40,000 *owed*, but not payable now, as *accrued wages.*

Transaction 5

By July 22, the workers had completed 1,000 pairs of jeans. Ramaswamy went around with an 'I was always sure the work would get done well' look, admiringly patting the jeans.

Fill up the Blue Solution Sheet after this transaction.

Hint: The Blue Company now *owns* 1,000 finished jeans. The workers have done their Rs. 80,000 job.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Blue Company as of 22nd July

ITEM	OPENING BALANCE SHEET	TRANSACTION 5		**CLOSING BALANCE SHEET**
ASSETS [OWNED]				
Building	50,000			50,000
Equipment	200,000			200,000
Furniture	20,000			20,000
Stocks–Raw Mat.				
Stocks–WIP	140,000	—	140,000	0
Stocks–Fin. Goods	0	+	180,000	180,000
Cash	230,000			230,000
TOTAL ASSETS	640,000			680,000
LIABILITIES [OWED]				
Capital	200,000			200,000
Bank Loan	300,000			300,000
Creditors	100,000			100,000
Accrued Wages	40,000	+	40,000	80,000
TOTAL LIABILITIES	640,000			680,000

Explanation for Transaction 5

Stocks-WIP	With the addition of another Rs. 40,000 worth of labour, the jeans have been completed, and are no longer work-in-progress.
Stocks—Fin. Goods	The company now *owns* Rs. 180,000 worth of finished goods consisting of Rs. 100,000 worth of material and Rs. 80,000 worth of labour.
Accrued Wages	The company has now obtained Rs. 80,000 worth of work from the team. This amount need not be paid till the month-end.

Transaction 6

Ramaswamy delivered his consignment to the ministry on July 24. By then the ministry had decided that they either wanted baggies or shorts, but certainly not jeans. However, "as the government always keeps its word…blah… blah…", they agreed to take delivery of jeans and pay as scheduled.

Fill up the Blue Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Blue Company as of 24th July

ITEM	OPENING BALANCE SHEET	TRANSACTION 6		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Building	50,000			50,000
Equipment	200,000			200,000
Furniture	20,000			20,000
Stocks–Raw Mat.				
Stocks–WIP				
Stocks–Fin. Goods	180,000	—	180,000	0
Debtors	0	+	250,000	250,000
Cash	230,000			230,000
TOTAL ASSETS	680,000			750,000
LIABILITIES [OWED]				
Capital	200,000			200,000
Retained Earnings	0	+	70,000	70,000
Bank Loan	300,000			300,000
Creditors	100,000			100,000
Accrued Wages	80,000			80,000
TOTAL LIABILITIES	680,000			750,000

Explanation for Transaction 6

Stocks—Fin. Goods	The entire stock of finished goods has been delivered to the ministry.
Debtors	The ministry is now indebted to the Blue Company to the extent of the contracted amount of Rs. 250,000.
Retained Earnings	The company has made a profit of Rs. 70,000 on this deal, after material costs of Rs. 100,000 and labour costs of Rs. 80,000 have been accounted for. [Rs. 250,000 minus Rs. 180,000].

The income statement is provided at the end of this exercise.

Transaction 7

On July 31, the Ministry paid the amount due. The Blue Company, in turn, paid the supplier of cloth and the workers.

Fill up the Blue Solution Sheet after this transaction.

Stop ***Do not turn over this page till you have given it some thought.***

Turn over this page for the solution.

Balance Sheet of the Blue Company as of 31st July

ITEM	OPENING BALANCE SHEET	TRANSACTION 7		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Building	50,000			50,000
Equipment	200,000			200,000
Furniture	20,000			20,000
Stocks–Raw Mat.				
Stocks–WIP				
Stocks–Fin. Goods				
Debtors	250,000	—	250,000	0
Cash	230,000	+	70,000	300,000
TOTAL ASSETS	750,000			570,000

ITEM	OPENING BALANCE SHEET	TRANSACTION 7		CLOSING BALANCE SHEET
LIABILITIES [OWED]				
Capital	200,000			200,000
Retained Earnings	70,000			70,000
Bank Loan	300,000			300,000
Creditors	100,000	—	100,000	0
Accrued Wages	80,000	—	80,000	0
TOTAL LIABILITIES	750,000			570,000

Explanation for Transaction 7

Debtors The ministry no longer *owes* money to the Blue Company.

Cash The cash balance has increased by Rs. 70,000. [Rs. 250,000 received from the debtor minus Rs. 100,000 and Rs. 80,000 paid to the creditor and the workers, respectively].

Creditors The company no longer *owes* money to creditors.

Accrued Wages The company also no longer *owes* money to the workers.

Income Statement of the Blue Company for the Period July 1 to July 31

		Rupees
Sales		250,000
Expenses:		
Material	100,000	
Labour	80,000	180,000
Profits		70,000

The Blue Company has sold for Rs. 250,000, the jeans which the company produced at a total cost [material and labour] of Rs. 180,000, thus making a profit of Rs. 70,000.

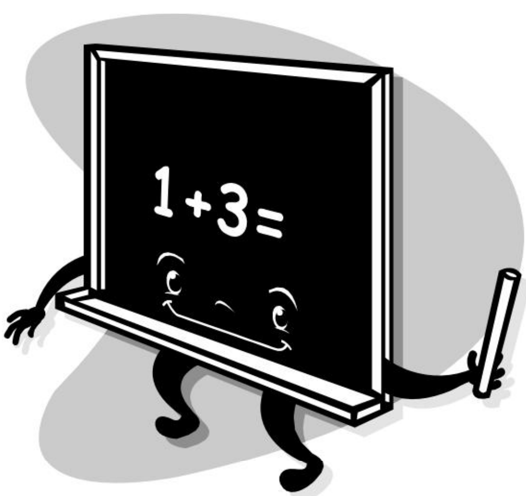
THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

The McGraw-Hill Companies

CHAPTER 4

The Brown Company (More Manufacturing)

AUGUST



THE BEGINNING

Ramaswamy was a little concerned about his health. So far he had avoided business transactions that could complicate his accounting. In the Blue Company, he had carefully ensured that there were no part-conversions of raw material to WIP, and of WIP to finished goods. Again the finished goods were sold completely. He was also conscious that he had not accounted for interest costs and depreciation. Nor had he paid out a dividend. The income tax man was after him.

He started the Brown Company with a capital of Rs. 300,000, to produce cheap trousers. On August 1, the company used this capital and a Rs. 400,000 bank loan to buy a building for Rs. 100,000, equipment for Rs. 250,000, and furniture worth Rs. 50,000. The company also bought Rs. 150,000 worth of cloth, enough for 3,000 pairs of trousers.

First fill up the opening balance sheet. No explanation is provided since these are similar to the initial transactions of the Blue Company. Find out the cash balance.

Transaction 1

Each pair of trousers requires Rs. 50 worth of cloth and Rs. 30 worth of labour. The workers' wages for August had to be paid on September 7.

Work started on 2,000 pairs of trousers. By August 5, these trousers were half-complete in terms of labour.

Fill up the Brown Solution Sheet after this transaction.

Hint: Determine how much raw material is left untouched. Value the incomplete work in terms of the two inputs: material and labour.

Stop *Do not turn over this page till you have given it some thought.*

Turn over this page for the solution.

Balance Sheet of the Brown Company as of 5th August

ITEM	OPENING BALANCE SHEET	TRANSACTION 1		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Building	100,000			100,000
Equipment	250,000			250,000
Furniture	50,000			50,000
Stocks–Raw Mat.	150,000	—	100,000	50,000
Stocks–WIP	0	+	130,000	130,000
Cash	150,000			150,000
TOTAL ASSETS	700,000			730,000
LIABILITIES [OWED]				
Capital	300,000			300,000
Bank Loan	400,000			400,000
Accrued Wages	0	+	30,000	30,000
TOTAL LIABILITIES	700,000			730,000

Explanation for Transaction 1

Stocks—Raw Mat. Out of the opening raw material stocks of Rs. 150,000, Rs. 100,000 of material [corresponding to 2,000 units] has been converted to partly finished trousers—WIP.

Stocks-WIP

Item [1]	Units [2]	Rate [3]	% Complete [4]	Total [2×3×4] Rs.
Material	2000	Rs. 50	100	100,000
Labour	2000	Rs. 30	50	30,000
				130,000

The WIP consists of 2000 units. Each unit has 100% of the material of a complete pair of trousers, but only 50% of the labour needed for a complete pair. In the above table, the number of units is multiplied by the rate per unit and by the percentage of completion.

Accrued Wages The Brown Company has used labour worth Rs. 30,000. The wages are payable only in the beginning of the following month.

Transaction 2

By August 10, the Brown Company completed 1500 pairs of trousers. 500 pairs were left half-complete.

Fill

Fill up the Brown Solution Sheet after this transaction.

Hint: Remember that the Brown Company has raw material, partly completed, and fully completed stocks. Follow the tabular format [used in explanation for transaction 1] for your computation.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Brown Company as of 10th August

ITEM	OPENING BALANCE SHEET	TRANSACTION 2		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Building	100,000			100,000
Equipment	250,000			250,000
Furniture	50,000			50,000
Stocks–Raw Mat.	50,000			50,000
Stocks–WIP	130,000	—	97,500	32,500
Stocks–Fin. Goods	0	+	120,000	120,000
Cash	150,000			150,000
TOTAL ASSETS	730,000			752,500
LIABILITIES [OWED]				
Capital	300,000			300,000
Bank Loan	400,000			400,000
Accrued Wages	30,000	+	22,500	52,500
TOTAL LIABILITIES	730,000			752,500

Explanation for Transaction 2

Stocks—WIP

Item [1]	Units [2]	Rate [3]	% Complete [4]	Total [2×3×4] Rs.
Material	500	Rs. 50	100	25,000
Labour	500	Rs. 30	50	7,500
				32,500

The WIP consists of 500 units. Each unit has 100% of the material of a complete pair of trousers, but only 50% of the labour needed for a complete pair. In the above table, the number of units is multiplied by the rate per unit and by the percentage of completion.

Stocks—Fin. Goods

Item [1]	Units [2]	Rate [3]	% Complete [4]	Total [2×3×4] Rs.
Material	1500	Rs. 50	100	75,000
Labour	1500	Rs. 30	100	45,000
				120,000

Accrued Wages The Brown Company has used labour worth Rs. 52,500 [Rs. 7,500 in *stocks—WIP* plus Rs. 45,000 in *stocks—fin. goods*].

Transaction 3

By August 30, the Brown Company had sold 1000 pairs of trousers at Rs. 120 per pair. The buyer agreed to pay by September 15. No further manufacturing took place after August 10.

Fill up the Brown Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Brown Company as of 30th August

ITEM	OPENING BALANCE SHEET	TRANSACTION 3		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Building	100,000			100,000
Equipment	250,000			250,000
Furniture	50,000			50,000
Stocks–Raw Mat.	50,000			50,000
Stocks–WIP	32,500			32,500
Stocks–Fin. Goods	120,000	—	80,000	40,000
Debtors	0	+	120,000	120,000
Cash	150,000			150,000
TOTAL ASSETS	752,500			792,500
LIABILITIES [OWED]				
Capital	300,000			300,000
*Retained Earnings**	0	+	**40,000**	**40,000**
Bank Loan	400,000			400,000
Accrued Wages	52,500			52,500
TOTAL LIABILITIES	752,500			792,500

Explanation for Transaction 3

Stocks—Fin. Goods On August 10, the Brown Company had 1,500 pairs of completed trousers which cost Rs. 80 each to produce [Rs. 50 material plus Rs. 30 labour]. Having sold 1,000 pairs by August 30, the company now has 500 pairs of finished trousers in stock worth Rs. 40,000 at Rs. 80 per pair.

Debtors The company now *owns* a claim of Rs. 120,000 arising from the sales. The buyer is indebted to the company for this amount.

*Retained Earnings** This sale has given the company a profit of Rs. 40,000. Each of the 100 pairs sold, gave a profit of Rs. 40 [sale price Rs. 120 minus cost Rs. 80].

*An asterisk is suffixed to *retained earnings* since interest, depreciation, income tax, and dividends have not yet been accounted for.

Notice that since no manufacturing took place after August 10, no addition to *accrued wages* has taken place.

Transaction 4

On August 31, Ramaswamy paid Rs. 4,000 to the bank as interest for August [one month's interest on Rs. 400,000 at 12% per annum].

Ramaswamy wanted to prepare the August income statement, and Munimji came to his rescue. "In addition to material, labour, and interest, you also have to charge depreciation of Rs. 6,000 on the fixed assets, to compute the profits before tax. On this profit you have to pay income tax at 30%, which I suggest you pay this morning. You can also pay 5% dividend on the capital of Rs. 300,000."

Prepare an income statement after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Income Statement of the Brown Company for the Period
August 1 to August 31

		Rupees
Sales		120,000
Expenses:		
Material	50,000	
Labour	30,000	80,000
Depreciation		6,000
Interest		4,000
Profit Before Tax		30,000
Income Tax @30%		9,000
Profit After Tax		21,000
Allocation of Profits		
Dividends @5% on Capital		15,000
Retained Earnings		6,000

Explanation for Transaction 4: Income Statement

The tentative profit calculation at the end of transaction 3 took into account material and labour.

The formal income statement also considers interest and depreciation for computing the **Profit Before Tax.**

On this **Profit Before Tax**, the Brown Company pays income tax of Rs. 9,000, at the rate of 30%. The **Profit After Tax**, for the month of August, is Rs. 21,000.

Out of this profit, the company pays as dividend Rs. 15,000 to the capital suppliers at 5% on the capital of Rs. 300,000, and retains the balance Rs. 6,000.

Depreciation The fixed assets acquired can be used by the company for several years. The entire cost should not, therefore, be treated as an expense in August itself in computing profits. Hence, a portion of the purchase cost, based on certain assumptions, is treated as *depreciation* expense in August.

This *depreciation* expense differs from other expenses met so far [material, labour, and interest], in that there will never be a related cash outflow.

It is best to view depreciation as an allocation of the purchase cost of a fixed asset over its life.

Transaction 4 [continued]

Fill up the Brown Solution Sheet after this transaction.

Hint: Compute the cash outflows in transaction 4. Adjust the total fixed asset value for the depreciation expense in August. Replace the provisional retained earnings* with the final amount calculated in the income statement.

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Brown Company as of 31st August

ITEM	OPENING BALANCE SHEET	TRANSACTION 4		**CLOSING BALANCE SHEET**
ASSETS [OWNED]				
Building	100,000			100,000
Equipment	250,000			250,000
Furniture	50,000			50,000
Gross Fixed Assets	400,000			400,000
Accumulated Depr.	0	+	6,000	6,000
Net Fixed Assets	400,000			394,000
Stocks–Raw Mat.	50,000			50,000
Stocks–WIP	32,500			32,500
Stocks–Fin. Goods	40,000			40,000
Debtors	120,000			120,000
Cash	150,000	—	28,000	122,000
TOTAL ASSETS	792,500			758,500
LIABILITIES [OWED]				
Capital	300,000			300,000
Retained Earnings	**40,000**	—	**34,000**	6,000
Bank Loan	400,000			400,000
Accrued Wages	52,500			52,500
TOTAL LIABILITIES	792,500			758,500

Explanation for Transaction 4: Balance Sheet

Gross Fixed Assets	This is the total purchase value of all fixed assets.
Accumulated Depreciation [Depr.]	This is the cumulative value of depreciation on fixed assets, treated as expense in the income statement. The Brown Company started in August and the depreciation expense of August is the cumulative depreciation expense. In September, for instance, the depreciation expenses of August and September will be the accumulated depreciation.
Net Fixed Assets	This is the net value of the fixed assets. This value is obtained by subtracting *accumulated depreciation* from gross fixed assets.
Cash	Rs. 28,000 cash is paid out [interest Rs. 4,000, income tax Rs. 9,000, and dividends Rs. 15,000].
TOTAL ASSETS	This is the total of net fixed assets, stocks, debtors and cash.
Retained Earnings	At the end of transaction 3, the tentative *retained earnings** were Rs. 40,000. This amount reduces by Rs. 34,000 [interest, depreciation, tax and dividends] to Rs. 6,000.

Note: Showing the tentative value of Rs. 40,000 in the first step and the final value in the second has been done to aid clarification.

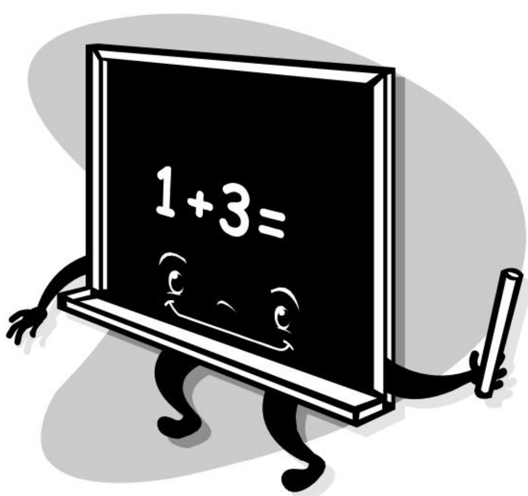
A single step calculation of the *retained earnings* is usual.

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

CHAPTER 5

The Red Company (A Brief Tragedy)

SEPTEMBER



THE BEGINNING

It was a wonderfully pleasant September and Ramaswamy was in an optimistic empire-building mood. “Only a small-time operator believes that a free market is a free market,” he said, “An entrepreneur like me has to learn to corner the market. I intend to start with the **bullion** market”.

Transaction I

Come September 1, Ramaswamy founded the Red Company with an initial capital of Rs. 225,000—all his own. He refused to let his friends subscribe to the capital. “The profits are going to be truly mind-boggling and will all be mine.”

The same evening, the Red Company bought Rs. 175,000 worth of silver for cash. His wife was a bit doubtful, “How can you corner the market with such small stocks?” she questioned.

Fill up the Red Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Red Company as of 1st September

ITEM	OPENING BALANCE SHEET	TRANSACTION 1		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Stocks	0	+	175,000	175,000
Cash	0	+	50,000	50,000
TOTAL ASSETS				225,000
LIABILITIES [OWED]				
Capital	0	+	225,000	225,000
TOTAL LIABILITIES				225,000

Explanation for Transaction 1

Stocks The Red Company *owns* silver stocks of Rs. 175,000.

Cash Out of the cash of Rs. 225,000 put in initially, Rs. 50,000 is now *owned* after buying the silver.

Capital The Red Company *owes* Ramaswamy, the only supplier of capital, Rs. 225,000.

Transaction 2

Alas for Ramaswamy! The government, frustrated over having nothing to regulate, decided on September 3 to control silver. Silver stocks could only be held by authorised dealers and Ramaswamy failed to get a licence.

On September 4, he was forced to sell his entire stock of silver to Honest Traders for Rs. 125,000. The buyer agreed to pay in a week's time.

Fill

Fill up the Red Solution Sheet after this transaction.

Hint: Obviously, the Red Company has made a loss. If profits add to the amount *owed* to the suppliers of capital, then what would losses do to the amount *owed*?

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Red Company as of 4th September

ITEM	OPENING BALANCE SHEET	TRANSACTION 2		**CLOSING BALANCE SHEET**
ASSETS [OWNED]				
Stocks	175,000	—	175,000	0
Debtors	0	+	125,000	125,000
Cash	50,000			50,000
Loss	0	+	50,000	50,000
TOTAL ASSETS	225,000			225,000
LIABILITIES [OWED]				
Capital	225,000			225,000
TOTAL LIABILITIES	225,000			225,000

Explanation for Transaction 2

Debtors The Red Company *owns* a claim of Rs. 125,000 on Honest Traders.

Stocks There is no stock of silver.

Loss The Red Company has suffered a loss of Rs. 50,000 on this deal. Just as profits 'belong' to the capital suppliers, losses are to be 'borne' by them.

Had the company made a profit of Rs. 50,000 on this deal, it would have *owed* Rs. 275,000 to the capital suppliers [initial capital plus profits].

Since the company has actually made a loss of Rs. 50,000 on this deal, it now *owes* Rs. 175,000 to the capital suppliers [initial capital minus the loss].

Just as profits made were shown separately as *retained earnings* [and not added to the *capital*], the loss is not reduced from *capital* but shown separately as *loss*. It is possible to reduce this loss from the liabilities, but accountants abhor subtraction.

Therefore, the usual practice is to add a *loss* item to the asset side.

Transaction 3

Luck had run out for Ramaswamy. On September 10, the Honest Traders paid Rs. 100,000 and made it clear that this was all they could pay. They were broke.

Fill up the Red Solution Sheet after this transaction.

Hint: Rs. 25,000 of the debt has gone bad.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Red Company as of 10th September

ITEM	OPENING BALANCE SHEET	TRANSACTION 3		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Stocks				
Debtors	125,000	—	125,000	0
Cash	50,000	+	100,000	150,000
Loss	50,000	+	25,000	75,000
TOTAL ASSETS	225,000			225,000
LIABILITIES [OWED]				
Capital	225,000			225,000
TOTAL LIABILITIES	225,000			225,000

Explanation for Transaction 3

Debtors The Red Company initially *owned* a claim of Rs. 125,000 on Honest Traders. Now, they do not *own* any claim on Honest Traders.

Cash The company has received Rs. 100,000 cash from Honest Traders in full settlement of the claim of Rs. 125,000.

Loss The debt of Rs. 25,000 which has gone bad for the company adds to the loss of Rs. 50,000 already made. [This Rs. 25,000 is treated as *bad debt* expense in the income statement].

Income Statement of the Red Company
for the Period September 1 to September 10

	Rupees
Sales	125,000
Expenses:	
Material	175,000
Bad Debts	25,000
Loss	75,000

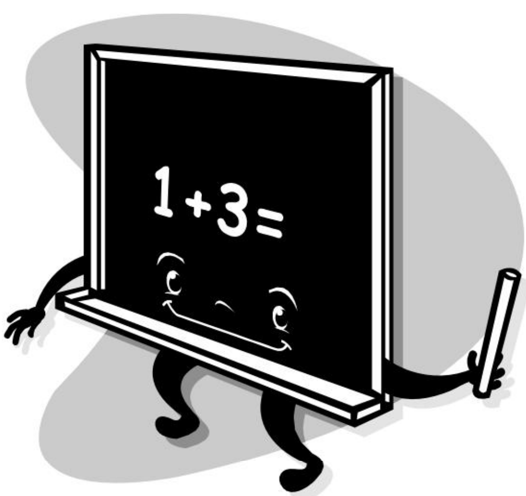
The Red Company has sold for Rs. 125,000, the material purchased for Rs. 175,000. Out of the sale value, Rs. 25,000 will not be collected, ever.

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

CHAPTER 6

The Orange Company

NOVEMBER



Balance Sheet of the Orange Company as of 31st October

ITEM	
ASSETS [OWNED]	
Equipment	300,000
Furniture	50,000
Gross Fixed Assets	350,000
Accumulated Depr.	6,500
Net Fixed Assets	343,500
Investments	125,000
Stocks–Raw Mat.	50,000
Stocks–WIP	56,000
Stocks–Fin. Goods	54,000
Debtors	100,000
Bank	171,500
TOTAL ASSETS	900,000
LIABILITIES [OWED]	
Capital	350,000
Retained Earnings	18,000
Bank Loan	380,000
Creditors	80,000
Accrued Wages	72,000
TOTAL LIABILITIES	900,000

THE STORY SO FAR

After the Red Company disaster, Ramaswamy decided to play safe. "Honest hard work has its own reward," said he, "If you don't speculate you will accumulate."

In early October, Ramaswamy and his friends founded the Orange Company primarily to manufacture hand-tailored jeans. The company rented a work-shed as an economy measure. Some funds were invested in gilt-edged securities paying a monthly interest.

The balance sheet of the company as of 31st October, at the end of the first month of operation is provided on the facing page. With the exception of two items explained below, the remaining items should be familiar to the readers.

Investments The Orange Company *owns* investments worth Rs. 125,000 in gilt-edged securities.

Bank The company has a current account with the bank. Payments are made by cheques on this account rather than from cash in hand [as in the previous exercises]. Similarly, receipts are credited to this account.

Transaction I

On November 3, the Orange Company received a cheque for Rs. 60,000 from a debtor, and issued cheques for Rs. 50,000 to creditors, and for Rs. 72,000 to workers.

Fill up the Orange Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Orange Company as of 3rd November

ITEM	OPENING BALANCE SHEET	TRANSACTION 1		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Equipment	300,000			300,000
Furniture	50,000			50,000
Gross Fixed Assets	350,000			350,000
Accumulated Depr.	6,500			6,500
Net Fixed Assets	343,500			343,500
Investments	125,000			125,000
Stocks–Raw Mat.	50,000			50,000
Stocks–WIP	56,000			56,000
Stocks–Fin. Goods	54,000			54,000
Debtors	100,000	—	60,000	40,000
Bank	171,500	—	62,000	109,500
TOTAL ASSETS	900,000			778,000
LIABILITIES [OWED]				
Capital	350,000			350,000
Retained Earnings	18,000			18,000
Bank Loan	380,000			380,000
Creditors	80,000	—	50,000	30,000
Accrued Wages	72,000	—	72,000	0
TOTAL LIABILITIES	900,000			778,000

Explanation for Transaction 1

None provided

The October 31 Balance Sheet revisited

Each completed pair of jeans requires Rs. 100 for cloth, and Rs. 80 worth of labour.

Each incomplete pair of jeans [shown in WIP] has around Rs. 40 worth of labour expended on it.

Each pair is sold for Rs. 250.

Verify that the stocks in the October 31 balance sheet represent cloth for 500 pairs, 400 incomplete pairs, and 300 completed pairs. Also verify that the debtors represent 400 pairs sold on credit.

Transaction 2

By November 29, the Orange Company bought another Rs. 100,000 worth of cloth. The partly completed pairs as of October 31, were all completed. Additionally, the company began work on another 600 pairs, which were half-complete by November 29.

All purchases were to be paid for in the first week of December; wages were to be paid on December 1.

500 pairs were exported and the payment was expected by mid-December.

Fill up the Orange Solution Sheet after this transaction.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Balance Sheet of the Orange Company as of 29th November

ITEM	OPENING BALANCE SHEET	TRANSACTION 2		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Equipment	300,000			300,000
Furniture	50,000			50,000
Gross Fixed Assets	350,000			350,000
Accumulated Depr.	6,500			6,500
Net Fixed Assets	343,500			343,500
Investments	125,000			125,000
Stocks–Raw Mat.	50,000	+	40,000	90,000
Stocks–WIP	56,000	+	28,000	84,000
Stocks–Fin. Goods	54,000	—	18,000	36,000
Debtors	40,000	+	125,000	165,000
Bank	109,500			109,500
TOTAL ASSETS	778,000			953,000
LIABILITIES [OWED]				
Capital	350,000			350,000
*Retained Earnings**	18,000	+	35,000	53,000
Bank Loan	380,000			380,000
Creditors	30,000	+	100,000	130,000
Accrued Wages	0	+	40,000	40,000
TOTAL LIABILITIES	778,000			953,000

Explanation for Transaction 2

We have provided below the movements in physical stocks, in units of pairs of trousers. The description below shows the increases and decreases in physical stocks. Check this out and then confirm the monetary amounts in the solution.

Stocks of Raw Materials: Purchased equivalent to 1,000 pairs and consumed equivalent to 600.

Stocks of WIP: Commenced work on 600 pairs and completed 400 pairs.

Stocks of Finished Goods: Completed 400 pairs and sold 500 pairs.

Transaction 3: Income Statement

November 30 was a busy day. The Orange Company received an interest warrant for Rs. 1,000 on the investments made. The company paid an interest of Rs. 2,500 on the bank loan, and the monthly rent of Rs. 1,500.

Ramaswamy strongly suspected that a debtor, from whom Rs. 2,500 was due, would default.

Depreciation of Rs. 6,500 on equipment and furniture would have to be provided for November.

Income tax at 30% of profits was paid. A 2% dividend was paid to the suppliers of capital.

Prepare an income statement after this transaction.

Hint: If the debtor had already defaulted then the profits and, hence, the retained earnings would be reduced by Rs. 2,500. While there is uncertainty about whether default will indeed take place, Ramaswamy's suspicion should be reflected in the income statement.

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Income Statement of the Orange Company for the Period November 1 to November 30

		Rupees
Sales		125,000
Interest Income		1,000
		126,000
Expenses:		
Material	50,000	
Labour	40,000	90,000
Rent		1,500
Depreciation		6,500
Interest		2,500
Bad Debt Provided		2,500
Profit Before Tax		23,000
Income Tax @ 30%		6,900
Profit After Tax		16,100
Allocation of Profits		
Dividends @ 2% on Capital		7,000
Retained Earnings		9,100

Explanation for Transaction 3: Income Statement

Bad Debt Provided

In the Red Company, there was strong evidence that part of the debt had gone sour; to that extent the company showed bad debt expenses.

In the Orange Company, Ramawamy is doubtful about ever receiving Rs. 2,500 from the debtor. Good accounting warrants that the income statement takes cognisance of this possibility by providing for a possible bad debt of Rs. 2,500.

Transaction 3: Balance Sheet

Fill up the Orange Solution Sheet after this transaction.

Hint: Ramaswamy's concrete suspicion about the debtor should also be reflected in the balance sheet. One way is to show against the claim [Debtors] of Rs. 65,000, a liability item, Provision—Bad Debt, of Rs. 2,500. These two items, taken together, indicate that the Orange Company expects to receive Rs. 62,500 from its debtors.

Do not turn over this page till you have given it some thought.

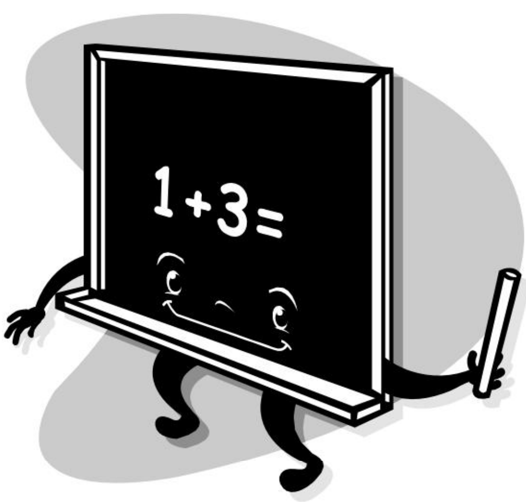
Turn over this page for the solution.
No explanation is provided. This exercise ends with the solution.

Balance Sheet of the Orange Company as of 30th November

ITEM	OPENING BALANCE SHEET	TRANSACTION 3		CLOSING BALANCE SHEET
ASSETS [OWNED]				
Equipment	300,000			300,000
Furniture	50,000			50,000
Gross Fixed Assets	350,000			350,000
Accumulated Depr.	6,500	+	6,500	13,000
Net Fixed Assets	343,500			337,000
Investments	125,000			125,000
Stocks–Raw Mat.	90,000			90,000
Stocks–WIP	84,000			84,000
Stocks–Fin. Goods	36,000			36,000
Debtors	165,000			165,000
Bank	109,500	—	16,900	92,600
TOTAL ASSETS	953,000			929,600
LIABILITIES [OWED]				
Capital	350,000			350,000
Retained Earnings	53,000	—	25,900	27,100
Bank Loan	380,000			380,000
Creditors	130,000			130,000
Accrued Wages	40,000			40,000
Provision–Bad Debt	0	+	2,500	2,500
TOTAL LIABILITIES	953,000			929,600

CHAPTER 7

Learning from Level-1



The Accounting Entity

By now you should be clear that accounts are maintained for a specific entity. For example, accounts were maintained for the Green Company as an entity distinct and separate from Ramaswamy. Accounting entities can be of different legal forms: proprietorship, partnership, private limited company, public limited company, or co-operative society.

Financial Statements

You have been exposed to two financial statements—the balance sheet and the income statement.

The Balance Sheet

The balance sheet shows what an entity *owns* and what it *owes*, at a **point in time**.

What an entity *owns* is called an ASSET, and what an entity *owes* is called a LIABILITY.

In the initial exercises, a balance sheet was prepared after each transaction. Later on, a balance sheet was prepared after several individual transactions spread over a few days. Normally, a firm would prepare a balance sheet at longer intervals such as monthly, quarterly, or yearly.

Each balance sheet was prepared by adding to an opening balance sheet, the consequences of subsequent transactions. A balance sheet of a given date is, therefore, the cumulative outcome of all the transactions since the inception of the entity.

In this book, balance sheet items are in a certain order. ASSETS begin with fixed assets [*buildings, equipment, furniture*], which are expected to be of use for several years. Then follow investments. Finally items such as *inventory, receivables* and *cash* are presented. These items are called current assets.

LIABILITIES begin with *capital* and *retained earnings*, followed by *loans*. Finally items such as *creditors* and *accrued wages* are presented. These items are called current liabilities.

The Income Statement

The income statement shows the profits earned by an entity in a **period of time**. In any given period of time, an entity may engage in various activities such as trading [buying and selling] and manufacturing [buying, processing, and selling].

Apart from sales, an entity may receive interest from investments, and so on.

Again, apart from material and labour expenses, an entity may have expenses such as rent, depreciation and interest.

Deducting all these expenses from sales and other income gives the profits earned in the period of time. On these profits, the entity may pay income-tax.

Finally, part of the profits made (after taxes) may be paid out as dividend, the remaining profits being retained.

Account-Heads

Account-heads used in this book may have different titles elsewhere. Some commonly used synonyms are:

Stocks	Inventories
Debtors	Sundry debtors, Receivables, Accounts Receivable
Capital	Share Capital
Retained Earnings	Reserves & Surplus
Creditors	Sundry Creditors, Payables, Accounts Payable

And Finally, Debits and Credits

A standard accounting text thrives on debits [*Dr.*] and credits [*Cr.*]. Strictly speaking these are *debtor* and *creditor.*

Historically, account-heads were personified. Just as Honest Traders is a debtor of the Red Company, *Mr. Cash* is also a debtor. Again *Mr. Building* is a debtor. Thus all ASSETS can be, and were viewed, as debtors. ASSETS, therefore, have a *debit* [Dr.] balance.

Indian accountants often treat their account-heads with great respect—*Shri Cashji*, and so on.

Guess what Shri Lossji means [no, this is not a cooked up example]. Remember the *Loss* shown as an asset in the Red Company? This is the honourable *Shri Lossji*!

Again, just as suppliers of raw material are creditors of the Yellow Company, so are *Mr. Capital* and *Mr. Provision—Bad Debt.* All LIABILITIES can be viewed as *creditors.* LIABILITIES, therefore, have a *credit* [*Cr.*] balance.

What about expenses, you may wonder. Stocks of raw materials, when consumed, are reflected as material expenses. Again, fixed assets, when used, are reflected as depreciation expenses. It is useful to recognize that many asset items are potential expenses waiting to be consumed.

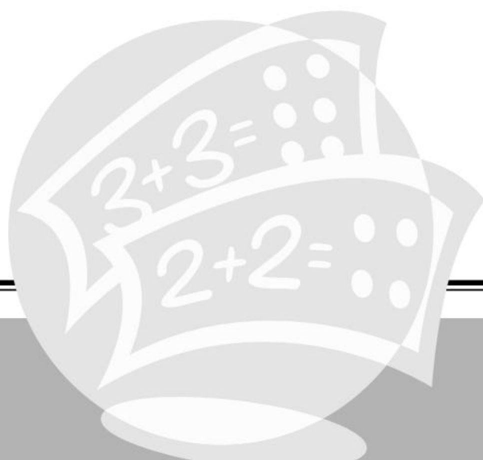
EXPENSE items, like ASSETS, have a *debit* [*Dr.*] sign. Similarly, INCOME items, like LIABILITIES, have a *credit* [*Cr.*] sign.

We understand your impatience to know more about debits and credits. You will have a lot of it in Level-2.

Level 2

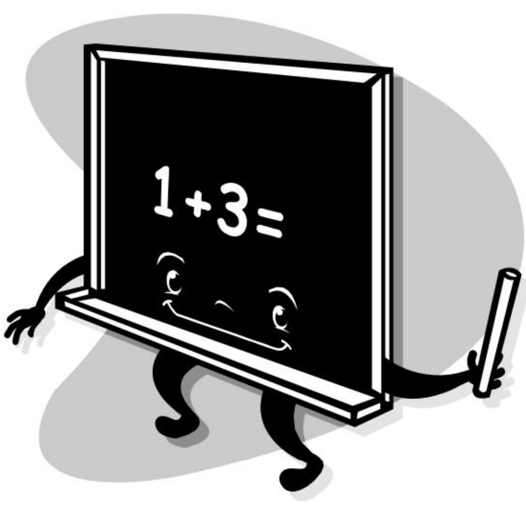
1

2



CHAPTER 8

Simple T-Accounts: An Introduction



LEVEL-1 REVISITED

In **Level-1**, each exercise consisted of a set of financial transactions, for a given period, relating to a specific company. A balance sheet was prepared after each transaction. This balance sheet reflected the assets [items *owned* by the company] and the liabilities [items *owed* by the company]. An income statement was prepared at the end of the given period. These exercises were used to provide an understanding of the logic of accounting.

As each exercise had only a few transactions, the preparation of financial statements was comparatively simple.

However in real-life the number of transactions can be very large. Monthly volumes can range from several hundred to several thousand transactions. Hence, the accounting process used in **Level-1** would be too cumbersome and time-consuming. **Level-2** focuses on formal accounting systems, which can handle large volumes of transactions.

LEVEL-2

A formal accounting system uses a set of books and ledgers to record individual transactions. Summaries of transactions are reconciled in a trial balance. Finally, financial statements are prepared, using the trial balance. This level will guide you through formal accounting systems.

The first five exercises (chapters 8 to 12) introduce you to a reasonably comprehensive accounting system. You will learn to use ledgers (T-Accounts), trial balances, and financial statements. Chapter 13 uses full-fledged accounting systems (adding source documents, cash book and journal to the accounting system you learnt in the first five exercises).

Level-2 uses the same set of transactions covered in **Level-1**. This will help you to relate the formal accounting approach with the logic of accounting.

THE GREEN COMPANY

Transaction 1

1st April Ramaswamy started the Green Company, providing Rs. 100,000 as initial capital.

T-Account Recording

Cash **(Asset)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T1	*Capital*	100,000			
	Total			**Total**	

Capital **(Liability)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
			T1	*Cash*	100,000
	Total			**Total**	

In subsequent exercises an explanation will be provided immediately after these T-Accounts. But, for this first transaction, we will first discuss T-Accounts before providing an explanation for the first transaction.

What are T-Accounts?

1. Two T-Accounts, *Cash* and *Capital* are shown above. A T-Account is actually T-shaped (it requires a little imagination to visualize the T), and hence the name.
2. Each T-Account has two sides, debit and credit.
3. A T-Account consists of a title indicating the account-head. For clarification, account-heads have been classified as an asset, liability, income, or expense.
4. Each transaction is recorded in corresponding T-Accounts. Simple transactions will affect at least two T-Accounts. More complex transactions may affect more than two T-Accounts.
5. Each transaction records equal amounts in the debit and credit sides of the affected T-Accounts.
6. For clarity, each transaction is referred to in the T-Accounts by its number (T1, T2, and so on).
7. At the end of a given period the net debit or credit balance of all T-Accounts is determined to prepare the trial balance, and financial statements.

   In the solutions in this chapter the most recent transaction is **highlighted** in the corresponding T-Accounts, for clarity.

Recording Transactions in T-Accounts

The time has now come to talk about 'debits' and 'credits'.

By convention, additions to assets are recorded on the debit side of the corresponding T-Account. This convention has a historical basis. You will remember that *debtors* are assets. In the good old days all accounts assets were personified. For example the *cash* T-Account was Mr. Cash, and was effectively treated as a debtor to the company. That is, the cash balance of the company was due to the company from Mr. Cash. Therefore, *debtors* and all other assets were effectively treated as having a debtor or in current parlance a debit balance (often shortened to Dr.)

By the same logic, additions to liabilities are recorded on the credit side of the corresponding T-Account. You will remember that *creditors* are liabilities. Other liability accounts were treated as creditors of the company. For example the *bank loan* account was Mr. Bank Loan, and was effectively treated as a creditor of the company. That is, the company *owed* the bank loan amount to Mr. Bank Loan. Therefore, creditors and all other liabilities were effectively treated as having a creditor or in current parlance, a credit balance (often shortened to Cr.)

You will recollect that *stocks* are assets. When stocks are sold, assets reduce correspondingly and the material consumed is reflected as an expense. Therefore, additions to expenses are recorded on the debit side of the corresponding T-Account, just as additions to assets are.

If additions to expenses are recorded on the debit side, additions to income have to be recorded on the credit side of the corresponding T-Account.

Decreases in assets, liabilities, expenses and income will be recorded on the side opposite to where the increases are recorded. For example when a debtor pays, this payment is recorded on the credit side of the *debtor* T-Account.

These conventions are summarized below:

Item	Increase	Decrease
Asset	Debit	Credit
Liability	Credit	Debit
Expense	Debit	Credit
Income	Credit	Debit

Explanation for Transaction 1

The asset item *cash* has increased by Rs. 100,000, and there is a corresponding increase in the liability item *capital* of Rs. 100,000.

Cash, which is an asset item, has increased. Therefore, Rs. 100,000 is recorded in the debit side of the *cash* T-Account. Similarly, since capital which is a liability item has increased, Rs. 100,000 is recorded in the credit side of the *capital* T-Account. As stated in the fifth point regarding what T-Accounts are, equal amounts have been recorded in the debit and credit sides of these two T-Accounts.

Notice that the amounts are indicated against transaction number T1.

At this stage, if a balance sheet is prepared, the assets will consist of *cash* Rs. 100,000, and the liabilities will consist of *capital* Rs. 100,000.

We suggest that you read the section "What are T-Accounts" once more at this stage.

Transaction 2

2nd April The Green Company raised a bank loan of Rs. 50,000.

T-Account Recording

Cash **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1 **T2**	*Capital* ***Bank Loan***	100,000 **50,000**			
	Total			**Total**	

Capital **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1	*Cash*	100,000
	Total			**Total**	

Bank Loan **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T2	***Cash***	**50,000**
	Total			**Total**	

Explanation for Transaction 2

The asset item *cash* has increased by Rs. 50,000, and there is a corresponding increase in the liability item *bank loan* of Rs. 50,000.

Therefore, Rs. 50,000 has been recorded in the debit side of the asset item *cash*, and Rs. 50,000 has been recorded in the credit side of the liability item *bank loan*.

Notice that the amounts are indicated against transaction number T2.

At this stage, if a balance sheet is prepared the assets will consist of *cash* Rs. 150,000. The liabilities will be Rs. 150,000, consisting of *capital* Rs. 100,000 and *bank loan* Rs. 50,000. Verify this.

You may also refer to the balance sheet after transaction 2 of the Green Company in Level-1.

Transaction 3

3rd April The Green Company bought a shop building for Rs. 25,000, paying cash.

T-Account Recording

***Cash* (Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1	*Capital*	100,000	**T3**	***Building***	25,000
T2	*Bank Loan*	50,000			
	Total			**Total**	

***Capital* (Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1	*Cash*	100,000
	Total			**Total**	

***Bank Loan* (Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T2	*Cash*	50,000
	Total			**Total**	

Building **(Asset)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T3	***Cash***	**25,000**			
	Total			**Total**	

Explanation for Transaction 3

The asset item *cash* has decreased by Rs. 25,000, and there is a corresponding increase in the asset item *building* of Rs. 25,000.

Therefore, Rs. 25,000 has been recorded in the credit side of the asset item *cash*, and Rs. 25,000 has been recorded in the debit side of the asset item *building*.

Notice that the amounts are indicated against transaction number T3.

At this stage, if a balance sheet is prepared the assets will total Rs. 150,000, consisting of *cash* Rs. 125,000 (Rs. 1,00,000 + Rs. 50,000 – Rs. 25,000) and *building* Rs. 25,000. The liabilities will continue to be Rs. 150,000, consisting of *capital* Rs. 100,000 and *bank loan* Rs. 50,000. Verify this.

You may also refer to the balance sheet after transaction 3 of the Green Company in Level-1.

Transaction 4

4th April The Green Company bought stocks of sugar for Rs. 10,000, paying cash.

T-Account Recording

Cash **(Asset)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T1	*Capital*	100,000	T3	*Building*	25,000
T2	*Bank Loan*	50,000	**T4**	***Stocks***	**10,000**
	Total			**Total**	

Capital **(Liability)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
			T1	*Cash*	100,000
	Total			**Total**	

***Bank Loan* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T2	*Cash*	50,000
	Total			**Total**	

***Building* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Cash*	25,000			
	Total			**Total**	

***Stocks* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4	***Cash***	**10,000**			
	Total			**Total**	

Explanation for Transaction 4

The asset item *cash* has decreased by Rs. 10,000, and there is a corresponding increase in the asset item *stocks* of Rs. 10,000.

Therefore, Rs. 10,000 has been recorded in the credit side of the asset item *cash*, and Rs. 10,000 has been recorded in the debit side of the asset item *stocks.*

Notice that the amounts are indicated against transaction number T4.

At this stage, if a balance sheet is prepared the assets will total Rs. 150,000, consisting of *cash* Rs. 115,000, *building* Rs. 25,000, and *stocks* Rs. 10,000. The liabilities will continue to be Rs. 150,000, consisting of *capital* Rs. 100,000 and *bank loan* Rs. 50,000. Verify this.

You may also refer to the balance sheet after transaction 4 of the Green Company in Level-1.

Transaction 5

5th April The Green Company sold the entire stocks of sugar for Rs. 12,000, receiving cash.

T-Account Recording

Cash **(Asset)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T1	*Capital*	100,000	T3	*Building*	25,000
T2	*Bank Loan*	50,000	T4	*Stocks*	10,000
T5a	***Sales***	**12,000**			
	Total			**Total**	

Capital **(Liability)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
			T1	*Cash*	100,000
	Total			**Total**	

Bank Loan **(Liability)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
			T2	*Cash*	50,000
	Total			**Total**	

Building **(Asset)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T3	*Cash*	25,000			
	Total			**Total**	

Stocks **(Asset)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T4	*Cash*	10,000	**T5b**	***Cost of Goods Sold***	**10,000**
	Total			**Total**	

Cost of Goods Sold **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T5b	*Stocks*	10,000			
	Total			Total	

Sales **(Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T5a	*Cash*	12,000
	Total			Total	

This is a tricky transaction, and has been explained in two parts, T5a and T5b.

The entire stocks bought for Rs. 10,000 were sold for Rs. 12,000. Thus, not only are the asset items *cash* and *stocks* affected, but income and expense account-heads are also affected.

Explanation for Transaction 5a

The asset item *cash* has increased by Rs. 12,000, and there is a corresponding increase in the income item *sales* of Rs. 12,000.

Therefore, Rs. 12,000 has been recorded in the debit side of the asset item *cash*, and Rs. 12,000 has been recorded in the credit side of the income item *sales*.

Notice that the amounts are indicated against transaction number T5a.

Explanation for Transaction 5b

All the stock of sugar bought for Rs. 10,000 was sold, and this Rs. 10,000 represents the cost of the sugar that was sold. The Green Company does not have sugar stock any more. Effectively, the asset of sugar stocks has become an expense as a result of the sales made.

The asset item *stocks* has decreased by Rs. 10,000, and there is a corresponding increase in the expense item *cost of goods sold* of Rs. 10,000.

Therefore, Rs. 10,000 has been recorded in the credit side of the asset item *stocks*, and Rs. 10,000 has been recorded in the debit side of the expense item *cost of goods sold*.

Notice that the amounts are indicated against transaction number T5b.

At this stage, if a balance sheet is prepared, the assets will total Rs. 152,000, consisting of *cash* Rs. 127,000, *building* Rs. 25,000, and zero *stocks*. The liabilities will be Rs. 152,000, consisting of *capital* Rs. 100,000, *bank loan* Rs. 50,000, and *retained earnings* Rs. 2,000. This *retained earnings* consists of the profits for the period [*sales* Rs. 12,000 minus *cost of goods sold* Rs. 10,000] retained in the Green Company.

You may also refer to the balance sheet after transaction 5 of the Green Company in Level-1.

Preparing Financial Statements

Given these transactions for the Green Company, the preparation of financial statements for the Green Company involves the following steps:

Step 1 Find out the closing balances in each T-Account. These balances will represent the net impact of all the transactions affecting a particular T-Account.

Step 2 Prepare a statement reconciling the debit and credit balances in T-Accounts. This statement is called a trial balance. This is to ensure that there are no arithmetical errors in the T-Account balances.

Step 3 Prepare the income statement and the balance sheet on the basis of the trial balance.

Let us do these.

Step I Closing the T-Accounts

***Cash* (Asset)**

Debit — **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1	*Capital*	100,000	T3	*Building*	25,000
T2	*Bank Loan*	50,000	T4	*Stocks*	10,000
T5a	*Sales*	12,000		Bal c/d	127,000
	Total	162,000		**Total**	162,000
	Bal b/d	127,000			

***Capital* (Liability)**

Debit — **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	100,000	T1	*Cash*	100,000
	Total	100,000		**Total**	100,000
				Bal b/d	100,000

Bank Loan **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	50,000	T2	*Cash*	50,000
	Total	50,000		**Total**	50,000
				Bal b/d	50,000

Building **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Cash*	25,000		Bal c/d	25,000
	Total	25,000		**Total**	25,000
	Bal b/d	25,000			

Stocks **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4	*Cash*	10,000	T5b	*Cost of Goods Sold*	10,000
	Total	10,000		**Total**	10,000

Cost of Goods Sold **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T5b	*Stocks*	10,000		Bal c/d	10,000
	Total	10,000		**Total**	10,000
	Bal b/d	10,000			

Sales **(Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	12,000	T5b	*Cash*	12,000
	Total	12,000		**Total**	12,000
				Bal b/d	12,000

Explanation for Closing of T-Accounts

Users may be shocked by the previous page. Let us understand what was done and why. The purpose of closing the T-Accounts is to determine the net impact of all the transactions in a given period of time.

The *cash* account will be used to illustrate this. For a layman, determining the cash balance as of 5th April is child's play. The Green Company received an amount of Rs. 162,000 between 1st April and 5th April. The company paid out Rs. 35,000 in the same period. The cash remaining as of 5th April is, therefore, Rs. 127,000.

An accountant arrives at the same figure in the following fashion. First, she totals up the debit and the credit sides using a pencil. In this case the debit total is Rs. 162,000 and the credit total Rs. 35,000. Then she records the higher figure (Rs. 162,000) on both the sides. She next places the difference (Rs. 127,000) in the side with the lower original total [in this case, the credit side]. This difference is called the balance carried down (bal c/d). Now the two sides will have identical totals, keeping the accountant happy. Finally, she records this difference on the side with the higher original total [in this case, the debit side]. This amount is called the balance brought down (bal b/d). After all this rigmarole the T-Account shows the net effect of all the transactions for a given period of time. She is now clear that the Green Company has a cash balance of Rs. 127,000. Phew!

Stocks has a zero balance, since all the materials bought were fully sold. Formally, in accounting parlance, stocks consumed and sold are reflected in the *cost of goods sold.*

Step 2 Preparing a Trial Balance

Now that all the T-Accounts have been closed, and the closing balances in each account ascertained, we can go ahead and prepare the financial statements. As an intermediate step to the preparation of financial statements, a statement is prepared called the trial balance.

This statement is a record of the closing balances of all the T-Accounts. The debit and credit balances are placed in separate columns. The closing balances are totaled, and the debit and credit column totals should be equal. It is not surprising that these totals are equal. Remember that, while recording transactions in the T-Accounts, we ensured that for every amount recorded in the debit side, an equal amount was recorded in the credit side.

Trial Balance for the Green Company as of 5th April

	Debit	Credit
Cash	127,000	
Capital		100,000
Bank Loan		50,000
Building	25,000	
Stocks	0	
Cost of Goods Sold	10,000	
Sales		12,000
Total	**162,000**	**162,000**

The T-Account closing balances have been recorded above. Although *stocks* has a zero balance, the account-head has been included for completeness.

Step 3 Preparing Financial Statements

On the basis of the trial balance, the balance sheet and income statement of the Green Company are prepared.

Step 3a The Income Statement

The income statement is first prepared using all the trial balance account-heads relating to income and expenses. Out of the seven T-Account balances in the trial balance, two of them relating to the income statement are used here. These are *sales* and *cost of goods sold*.

Income Statement of The Green Company for the Period 1st April to 5th April

	Rupees
Sales	12,000
Expenses:	
Cost of Goods Sold (Material)	10,000
Profits	2,000

Notice that this is the same format used in Level-1. However, accountants have a more formal style of presentation—they use a T-Account titled ***Profit & Loss Account***, in place of an income statement.

***Profit & Loss Account* for the Period 1st April to 5th April**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Cost of Goods Sold	10,000		*Sales*	12,000
	Profits (Bal c/d)	2,000			
	Total	12,000		**Total**	12,000

This T-Account has the same information content as the income statement.

Step 3b The Balance Sheet

The balance sheet is prepared using all the trial balance account-heads relating to assets and liabilities. Additionally, the profits made in the period and retained have to be shown as *retained earnings.*

Balance Sheet of the Green Company as of 5th April

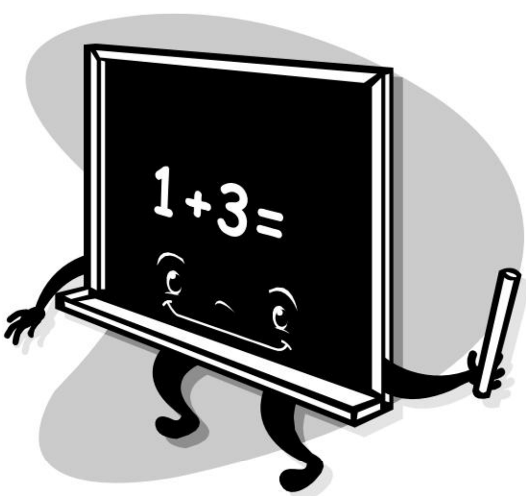
Building	25,000
Stocks	0
Cash	127,000
TOTAL ASSETS	**152,000**
Capital	100,000
Retained Earnings	2,000
Bank Loan	50,000
TOTAL LIABILITIES	**152,000**

You may also refer to the balance sheet after transaction 5 of the Green Company in Level-1.

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

CHAPTER 9

Simple T-Accounts: Do-It-Yourself



THE YELLOW COMPANY

Ramaswamy started the Yellow Company in May primarily to sell cement. Also, he wanted an excuse to borrow from his wife. The transactions of the Yellow Company are listed below.

Transaction

1st May	T1a	Ramaswamy started the Yellow Company, providing Rs. 50,000 as the initial capital.
	T1b	Mrs. Ramaswamy made available an interest-free loan of Rs. 75,000 to the Yellow Company.
3rd May	T2	The Yellow Company bought office furniture for Rs. 10,000 paying cash.
10th May	T3	The Yellow Company bought Rs. 50,000 worth of cement on credit.
15th May	T4	The Yellow Company sold the entire stocks for Rs. 60,000 on credit.
22nd May	T5	The cement purchaser paid the entire Rs. 60,000.
23rd May	T6	In turn, the Yellow Company paid the cement supplier the Rs. 50,000 due.
31st May	T7	The Yellow Company repaid Rs. 25,000 to Mrs. Ramaswamy.

Enter these in the appropriate T-Accounts provided in the following two pages.

T-Account Recording

Cash **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Capital **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Furniture **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Loan–Mrs. Ramaswamy **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Stocks **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Creditors **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Debtors **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Cost of Goods Sold **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Sales **(Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Solution to the T-Accounts

The solution is provided below.

Cash **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	50,000	T2	*Furniture*	10,000
T1b	*Loan–Mrs. Ramaswamy*	75,000	T6	*Creditors*	50,000
T5	*Debtors*	60,000	T7	*Loan–Mrs. Ramaswamy*	25,000
	Total			Total	

Capital **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1a	*Cash*	50,000
	Total			Total	

Furniture **(Asset)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T2	*Cash*	10,000			
	Total			**Total**	

Loan–Mrs. Ramaswamy **(Liability)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T7	*Cash*	25,000	T1b	*Cash*	75,000
	Total			**Total**	

Stocks (Asset)

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T3	*Creditors*	50,000	T4b	*Cost of Goods Sold*	50,000
	Total			**Total**	

Creditors (Liability)

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T6	*Cash*	50,000	T3	*Stocks*	50,000
	Total			**Total**	

Debtors **(Asset)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T4a	*Sales*	60,000	T5	*Cash*	60,000
	Total			**Total**	

Cost of Goods Sold **(Expense)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4b	*Stocks*	50,000			
	Total			Total	

Sales **(Income)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T4a	*Debtors*	60,000
	Total			Total	

Preparing Financial Statements

Step I Closing the T-Accounts

Close the T-Accounts of the Yellow Company as was done in the Green Company. The appropriate sides for the balance carried down and the balance brought down have already been indicated.

Cash **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	50,000	T2	*Furniture*	10,000
T1b	*Loan–Mrs. Ramaswamy*	75,000	T6	*Creditors*	50,000
T5	*Debtors*	60,000	T7	*Loan–Mrs. Ramaswamy*	25,000
				Bal c/d	
	Total			Total	
	Bal b/d				

Capital **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d		T1a	*Cash*	50,000
	Total			Total	
				Bal b/d	

Furniture **(Asset)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T2	*Cash*	10,000		Bal c/d	
	Total			**Total**	
	Bal b/d				

Loan–Mrs. Ramaswamy **(Liability)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T7	*Cash* Bal c/d	25,000	T1b	*Cash*	75,000
	Total			**Total**	
				Bal b/d	

Stocks **(Asset)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T3	*Creditors*	50,000	T4b	*Cost of Goods Sold*	50,000
	Total			**Total**	

Creditors **(Liability)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T6	*Cash*	50,000	T3	*Stocks*	50,000
	Total			**Total**	

Debtors **(Asset)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T4a	*Sales*	60,000	T5	*Cash*	60,000
	Total			**Total**	

Cost of Goods Sold **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4b	*Stocks*	50,000		Bal c/d	
	Total			**Total**	
	Bal b/d				

Sales **(Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d		T4a	*Debtors*	60,000
	Total			**Total**	
				Bal b/d	

Preparing Financial Statements

Step I Solution to Closing the T-Accounts

Cash **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	50,000	T2	*Furniture*	10,000
T1b	*Loan–Mrs. Ramaswamy*	75,000	T6	*Creditors*	50,000
T5	*Debtors*	60,000	T7	*Loan–Mrs. Ramaswamy*	25,000
				Bal c/d	100,000
	Total	185,000		**Total**	185,000
	Bal b/d	100,000			

Capital **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	50,000	T1a	*Cash*	50,000
	Total	50,000		**Total**	50,000
				Bal b/d	50,000

Furniture **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2	*Cash*	10,000		Bal c/d	10,000
	Total	10,000		**Total**	10,000
	Bal b/d	10,000			

Loan–Mrs. Ramaswamy **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T7	*Cash* Bal c/d	25,000 50,000	T1b	*Cash*	75,000
	Total	75,000		**Total**	75,000
				Bal b/d	50,000

Stocks **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Creditors*	50,000	T4b	*Cost of Goods Sold*	50,000
	Total	50,000		**Total**	50,000

Creditors **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T6	*Cash*	50,000	T3	*Stocks*	50,000
	Total	50,000		**Total**	50,000

Debtors **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4a	*Sales*	60,000	T5	*Cash*	60,000
	Total	60,000		**Total**	60,000

***Cost of Goods Sold* (Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4b	*Stocks*	50,000		Bal c/d	50,000
	Total	50,000		**Total**	50,000
	Bal b/d	50,000			

***Sales* (Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	60,000	T4a	*Debtors*	60,000
	Total	60,000		**Total**	60,000
				Bal b/d	60,000

Preparing Financial Statements

Step 2 Preparing a Trial Balance

Prepare a trial balance for the Yellow Company

Trial Balance for the Yellow Company as of 31st May

	Debit	Credit
Cash		
Capital		
Furniture		
Loan–Mrs. Ramaswamy		
Cost of Goods Sold		
Sales		
Total		

Preparing Financial Statements

Step 2 Solution to the Trial Balance

Trial Balance for the Yellow Company as of 31st May

	Debit	Credit
Cash	100,000	
Capital		50,000
Furniture	10,000	
Loan–Mrs. Ramaswamy		50,000
Cost of Goods Sold	50,000	
Sales		60,000
Total	**160,000**	**160,000**

Preparing Financial Statements

Step 3a The Income Statement and *Profit & Loss Account*

On the basis of the trial balance, prepare the income statement and the *profit & loss account* of the Yellow Company.

Income Statement of The Yellow Company for the Period
1st May to 31st May

	Rupees
Sales	
Expenses:	
Cost of Goods Sold (Material)	______
Profits	______

Profit & Loss Account **for the Period 1st May to 31st May**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Cost of Goods Sold Profits (Bal c/d)			*Sales*	
	Total			**Total**	

Preparing Financial Statements

Step 3a Solution to the Income Statement and *Profit & Loss Account*

Income Statement of The Yellow Company for the period 1st May to 31st May

	Rupees
Sales	60,000
Expenses:	
Cost of Goods Sold (Material)	50,000
Profits	10,000

***Profit & Loss Account* for the Period 1st May to 31st May**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Cost of Goods Sold	50,000		*Sales*	60,000
	Profits (Bal c/d)	10,000			
	Total	60,000		**Total**	60,000

Preparing Financial Statements

Step 3b The Balance Sheet

Balance Sheet of the Yellow Company as of 31st May

Furniture *Stocks* *Debtors* *Cash*	
TOTAL ASSETS	
Capital *Retained Earnings* *Loan–Mrs. Ramaswamy* *Creditors*	
TOTAL LIABILITIES	

Preparing Financial Statements

Step 3b Solution to the Balance Sheet

Balance Sheet of the Yellow Company as of 31st May

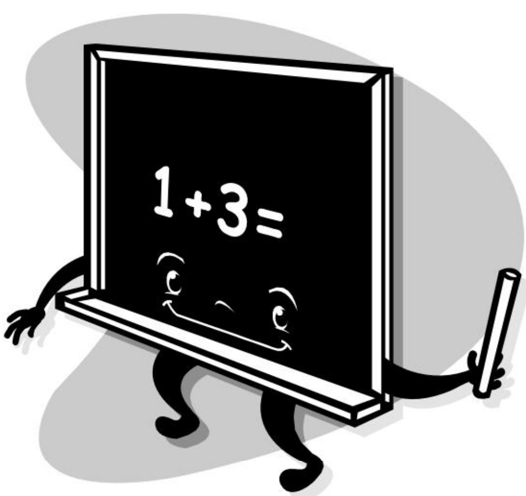
Furniture	10,000
Stocks	0
Debtors	0
Cash	100,000
TOTAL ASSETS	**110,000**
Capital	50,000
Retained Earnings	10,000
Loan–Mrs. Ramaswamy	50,000
Creditors	0
TOTAL LIABILITIES	**110,000**

You may also refer to the balance sheet after transaction 7 of the Yellow Company in Level-1.

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

CHAPTER 10

Taking Stock of Stocks



THE YELLOW COMPANY

No, this is not a printer's devil, we are going to account for the Yellow Company once more.

In chapters eight and nine we have been referring to the *cost of goods sold* (See transaction 5 of the Green Company and transaction 4 of the Yellow Company).

In these simple examples we were fortunate in knowing the exact cost of the goods sold. This was possible because both the companies carried on only trading. Also the entire stocks purchased were sold.

Real life can be much more complex. Instead of a single item like sugar or cement, there may be several items bought and sold. Secondly, some goods may remain unsold at the end of the accounting period. Finally, in the case of manufacturing organizations, *cost of goods sold* will consist not only of raw material costs, but also costs such as power, labour, and packaging. To determine the *cost of goods sold* for each sale transaction, may be well nigh impossible. But, obviously, profits for a period cannot be arrived at without taking into account all expenses including the *cost of goods sold.*

The first two exercises (chapters eight and nine) did not address this issue head on, because we wanted the user to be able to relate to Level-1. In this exercise, we will show you how to account for the cost of goods sold.

We show below the T-Accounts of the Yellow Company after transactions 1a, 1b, and 2 (see chapter nine). Make sure these are correct: do not take our word for it.

T-Account Recording

Cash **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	50,000	T2	*Furniture*	10,000
T1b	*Loan–Mrs. Ramaswamy*	75,000			
	Total			**Total**	

Capital **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1a	*Cash*	50,000
	Total			**Total**	

***Furniture* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2	*Cash*	10,000			
	Total			**Total**	

***Loan–Mrs. Ramaswamy* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1b	*Cash*	75,000
	Total			**Total**	

Now let us record transaction 3 in the T-Accounts.

10th May T3 The Yellow Company bought Rs. 50,000 worth of cement on credit.

***Cash* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	50,000	T2	Furniture	10,000
T1b	*Loan–Mrs. Ramaswamy*	75,000			
	Total			**Total**	

***Capital* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1a	*Cash*	50,000
	Total			**Total**	

***Furniture* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2	*Cash*	10,000			
	Total			**Total**	

***Loan–Mrs. Ramaswamy* (Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1b	*Cash*	75,000
	Total			**Total**	

Purchases

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Creditors*	50,000			
	Total			**Total**	

***Creditors* (Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T3	*Purchases*	50,000
	Total			**Total**	

Formal accounting may not have a T-Account for stocks, and neither do we now. Instead, purchases made are recorded as such in a *purchases* T-Account. This also provides managers information about the cost of purchases in a period. You may wonder what the difference is. Read on.

Next let us record transaction 4 in the T-Accounts.

15th May	T4	The Yellow Company made sales of Rs. 60,000 on credit.

***Cash* (Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	50,000	T2	*Furniture*	10,000
T1b	*Loan–Mrs. Ramawamy*	75,000			
	Total			**Total**	

***Capital* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1a	*Cash*	50,000
	Total			**Total**	

***Furniture* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2	*Cash*	10,000			
	Total			**Total**	

***Loan–Mrs. Ramaswamy* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1b	*Cash*	75,000
	Total			**Total**	

Purchases

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Creditors*	50,000			
	Total			**Total**	

***Creditors* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T3	*Purchases*	50,000
	Total			**Total**	

***Debtors* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4	*Sales*	60,000			
	Total			**Total**	

Sales **(Income)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T4	*Debtors*	60,000
	Total			**Total**	

If you have been alert, you may have noticed that there is a difference in the way T4 is described here and in chapter nine, and may wonder why. Patience!

Notice that transaction 4 is no longer split into two transactions (4a and 4b). The *sales* and *debtors* accounts are affected. As this transaction does not specify the cost of the goods sold, at this stage no entries are made relating to stocks. Such entries will only be made at the end of the accounting period to assess the cost of goods sold, and hence the profits.

The remaining transactions 5 to 7, are recorded as before in the T-Accounts.

22nd May T5 The cement purchaser paid the entire Rs. 60,000.
23rd May T6 In turn, the Yellow Company paid the cement supplier Rs. 50,000 due.
31st May T7 The Yellow Company repaid Rs. 25,000 to Mrs. Ramaswamy.

Step I The T-Accounts have also been Closed below.

Cash **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	50,000	T2	*Furniture*	10,000
T1b	*Loans–Mrs. Ramaswamy*	75,000	T6	*Creditors*	50,000
T5	*Debtors*	60,000	T7	*Loan–Mrs. Ramaswamy*	25,000
				Bal c/d	100,000
	Total	185,000		**Total**	185,000
	Bal b/d	100,000			

Capital **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	50,000	T1a	*Cash*	50,000
	Total	50,000		**Total**	50,000
				Bal b/d	50,000

Furniture **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2	*Cash*	10,000		Bal c/d	10,000
	Total	10,000		**Total**	10,000
	Bal b/d	10,000			

Loan–Mrs. Ramaswamy **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T7	*Cash*	25,000	T1b	Cash	75,000
	Bal c/d	50,000			
	Total	75,000		**Total**	75,000
				Bal b/d	50,000

Purchases

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Creditors*	50,000		Bal c/d	50,000
	Total	50,000		**Total**	50,000
	Bal b/d	50,000			

Creditors **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T6	*Cash*	50,000	T3	*Purchases*	50,000
	Total	50,000		**Total**	50,000

Debtors **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4	*Sales*	60,000	T5	*Cash*	60,000
	Total	60,000		**Total**	60,000

Sales **(Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	60,000	T4	*Debtors*	60,000
	Total	60,000		**Total**	60,000
				Bal b/d	60,000

Preparing Financial Statements

Step 2 Solution to the Trial Balance

Trial Balance for the Yellow Company as of 31st May

	Debit	Credit
Cash	100,000	
Capital		50,000
Furniture	10,000	
Loan–Mrs. Ramaswamy		50,000
Purchases	50,000	
Sales		60,000
Total	**1,60,000**	**1,60,000**

This trial balance contains *purchases* and not *cost of goods sold* as in chapter nine.

Preparing Financial Statements

Step 3a The Income Statement and *Profit & Loss Account*

The prepared trial balance is not enough to produce the income statement and *profit & loss account.* Can you guess why?

At this stage we do not know a major cost, the *cost of goods sold.* This cost in this trading example is the cost of material sold. Since we know the cost of the material purchased, the cost of material sold can be determined if the balance stock on hand is known.

Ramaswamy checked in the godown and found that the closing stock as of 31st May was zero. He had suspected this, since he had sold all that he had bought. In this case, the cost of material sold is Rs. 50,000–equal to the cost of purchases made.

Since the Yellow Company began with zero opening stock (as of 1st May), the cost of material sold in May is estimated by the following common-sensical relationship:

		Rupees
	Opening stock (as of 1 May)*	0
add	Cost of material purchased in May	50,000
minus	Closing stock (as of 31 May)	0
equals	Cost of material sold in May	**50,000**

*The opening stock is zero since the Yellow Company began with no stocks.

We prepare the income statement, using the computation above.

Income Statement of the Yellow Company for the Period 1st May to 31st May

	Rupees
Sales	60,000
Expenses:	
Cost of Goods Sold (Material)	50,000
Profits	10,000

Profit & Loss Account **for the Period 1st May to 31st May**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Opening Stock	0		*Sales*	60,000
	Purchases	50,000		*Closing Stock*	0
	Profits (Bal c/d)	10,000			
	Total	60,000		**Total**	60,000

The cost of material sold was computed earlier by adding the purchases to the opening stock, and then subtracting the closing stock. In the *profit & loss account*, the closing stock is not subtracted from the opening stock and purchases total. Instead it is placed on the credit side. The effect is the same.

Preparing Financial Statements

Step 3b Solution to the Balance Sheet

Balance Sheet of the Yellow Company as of 31st May

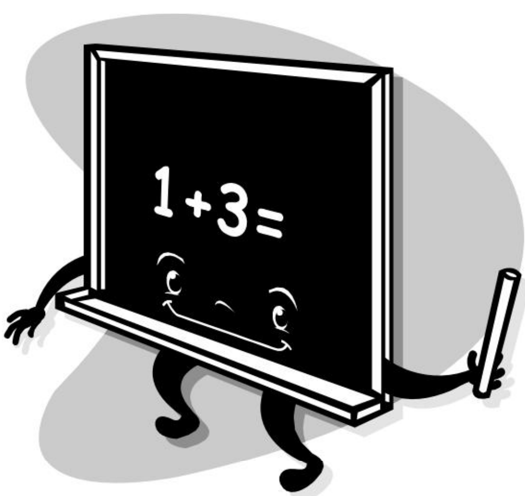
Furniture	10,000
Stocks	0
Debtors	0
Cash	100,000
TOTAL ASSETS	**110,000**
Capital	50,000
Retained Earnings	10,000
Loan–Mrs. Ramaswamy	50,000
Creditors	0
TOTAL LIABILITIES	**110,000**

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

The McGraw-Hill Companies

CHAPTER 11

Complex T-Accounts: An Introduction



THE BLUE COMPANY

In July, Ramaswamy started the Blue Company to manufacture garments. The first three transactions of the Blue Company are listed below. Enter these in the appropriate T-Accounts provided in the following pages.

Transaction

1st July	T1a	Ramaswamy started the Blue Company, providing Rs. 100,001 as the initial capital. His friends contributed another Rs. 99,999 of capital.
	T1b	The bank provided a loan of Rs. 300,000 to the Blue Company.
3rd July	T2	The Blue Company bought a building for Rs. 50,000, equipment for Rs. 200,000, and furniture for Rs. 20,000, paying cash.
7th July	T3	The Blue Company bought 2000 metres of cloth at Rs. 50 per metre, on credit.

This cloth was required to fulfil a contract for the supply of 1000 pairs of denim jeans. The selling price was Rs. 250 per pair.

T-Account Recording

Cash **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Capital **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Building **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

***Equipment* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

***Furniture* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

***Bank Loan* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Purchases

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

***Creditors* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Solution to the T-Accounts Transactions 1 to 3

***Cash* (Asset)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T1a	*Capital*	200,000	T2a	*Building*	50,000
T1b	*Bank Loan*	300,000	T2b	*Equipment*	200,000
			T2c	*Furniture*	20,000
	Total			**Total**	

***Capital* (Liability)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
			T1a	*Cash*	200,000
	Total			**Total**	

***Building* (Asset)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T2a	*Cash*	50,000			
	Total			**Total**	

***Equipment* (Asset)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T2b	*Cash*	200,000			
	Total			**Total**	

***Furniture* (Asset)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T2c	*Cash*	20,000			
	Total			**Total**	

Bank Loan **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1b	*Cash*	300,000
	Total			**Total**	

Purchases

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Creditors*	100,000			
	Total			**Total**	

Creditors **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T3	*Purchases*	100,000
	Total			**Total**	

Note that transaction 2 involves a total payment of Rs. 270,000 (Rs. 50,000 for the building, Rs. 200,000 for equipment, and Rs. 20,000 for furniture).

Transactions 4 and 5 are given below. How would you handle them?

15th July	T4	The entire cloth was cut by this date. No garments were completed.
22nd July	T5	1000 pairs of jeans were completed.

Good news. A formal accounting system will record neither of these transactions, unless a balance sheet is required on 15th July or 22nd July. In case a balance sheet is required on 15th July or 22nd July, the value of *stocks—WIP* and *stocks—fin. goods*, will appear on the balance sheet.

Within an accounting period, only purchases and sales are recorded. Remember the previous exercise **Taking Stock of Stocks**. Production of partly-completed or of fully-completed goods, will not be recorded.

Transactions 6 and 7 are given below. Enter these in the appropriate T-Accounts provided in the following page.

24 July	T6	Completed jeans were delivered to the ministry of commerce.
31 July	T7a	The ministry paid the sale amount of Rs. 250,000.
	T7b	The Blue Company paid its cloth supplier Rs. 100,000.
	T7c	The Blue Company paid the workers Rs. 80,000.

Fill up the T-Accounts in the following pages.

T-Account Recording

Cash **(Asset)**

Debit / **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	200,000	T2a	*Building*	50,000
T1b	*Bank Loan*	300,000	T2b	*Equipment*	200,000
			T2c	*Furniture*	20,000
	Total			**Total**	

Capital **(Liability)**

Debit / **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1a	*Cash*	200,000
	Total			**Total**	

Building **(Asset)**

Debit / **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2a	*Cash*	50,000			
	Total			**Total**	

Equipment **(Asset)**

Debit / **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2b	*Cash*	200,000			
	Total			**Total**	

Furniture **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2c	*Cash*	20,000			
	Total			**Total**	

Bank Loan **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1b	*Cash*	300,000
	Total			**Total**	

Purchases

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Creditors*	100,000			
	Total			**Total**	

Creditors **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T3	*Purchases*	100,000
	Total			**Total**	

Debtors **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			**Total**	

Sales **(Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Wages **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Solution to the T-Accounts Transactions 6 and 7

The solution is provided below. Now close the T-Accounts. Just to be helpful, we have not indicated bal c/d and bal b/d.

Cash **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	200,000	T2a	*Building*	50,000
T1b	*Bank Loan*	300,000	T2b	*Equipment*	200,000
T7a	*Debtors*	250,000	T2c	*Furniture*	20,000
			T7b	*Creditors*	100,000
			T7c	*Wages*	80,000
	Total			Total	

Capital **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1a	*Cash*	200,000
	Total			Total	

Building (Asset)

Ref	Head	Amount	Ref	Head	Amount
	Debit			**Credit**	
T2a	*Cash*	50,000			
	Total			**Total**	

Equipment (Asset)

Ref	Head	Amount	Ref	Head	Amount
	Debit			**Credit**	
T2b	*Cash*	200,000			
	Total			**Total**	

Furniture (Asset)

Ref	Head	Amount	Ref	Head	Amount
	Debit			**Credit**	
T2c	*Cash*	20,000			
	Total			**Total**	

Bank Loan (Liability)

Ref	Head	Amount	Ref	Head	Amount
	Debit			**Credit**	
			T1b	*Cash*	300,000
	Total			**Total**	

Purchases

Ref	Head	Amount	Ref	Head	Amount
	Debit			**Credit**	
T3	*Creditors*	100,000			
	Total			**Total**	

Creditors **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T7b	*Cash*	100,000	T3	*Purchases*	100,000
	Total			**Total**	

Debtors **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T6	*Sales*	250,000	T7a	*Cash*	250,000
	Total			**Total**	

Sales **(Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T6	*Debtors*	250,000
	Total			**Total**	

Wages **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T7c	*Cash*	80,000			
	Total			**Total**	

Step I Solution to Closing the T-Accounts

Cash **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	200,000	T2a	*Building*	50,000
T1b	*Bank Loan*	300,000	T2b	*Equipment*	200,000
T7a	*Debtors*	250,000	T2c	*Furniture*	20,000
			T7b	*Creditors*	100,000
			T7c	*Wages*	80,000
				Bal c/d	300,000
	Total	750,000		**Total**	750,000
	Bal b/d	300,000			

***Capital* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	200,000	T1a	*Cash*	200,000
	Total	200,000		**Total**	200,000
				Bal b/d	200,000

***Building* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2a	*Cash*	50,000		Bal c/d	50,000
	Total	50,000		**Total**	50,000
	Bal b/d	50,000			

***Equipment* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2b	*Cash*	200,000		Bal c/d	200,000
	Total	200,000		**Total**	200,000
	Bal b/d	200,000			

***Furniture* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T2c	*Cash*	20,000		Bal c/d	20,000
	Total	20,000		**Total**	20,000
	Bal b/d	20,000			

***Bank Loan* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	300,000	T1b	*Cash*	300,000
	Total	300,000		**Total**	300,000
				Bal b/d	300,000

Purchases

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Creditors*	100,000		Bal c/d	100,000
	Total	100,000		**Total**	100,000
	Bal b/d	100,000			

***Creditors* (Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T7b	*Cash*	100,000	T3	*Purchases*	100,000
	Total	100,000		**Total**	100,000

***Debtors* (Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T6	*Sales*	250,000	T7a	*Cash*	250,000
	Total	250,000		**Total**	250,000

***Sales* (Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	250,000	T6	*Debtors*	250,000
	Total	250,000		**Total**	250,000
				Bal b/d	250,000

***Wages* (Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T7c	*Cash*	80,000		Bal c/d	80,000
	Total	80,000		**Total**	80,000
	Bal b/d	80,000			

Preparing Financial Statements

Step 2 Preparing a Trial Balance

Prepare a trial balance as of 31st July

Trial Balance for the Blue Company as of 31st July

	Debit	Credit
Total		

Preparing Financial Statements

Step 2 Solution to the Trial Balance

Trial Balance for the Blue Company as of 31st July

	Debit	Credit
Cash	300,000	
Capital		200,000
Building	50,000	
Equipment	200,000	
Furniture	20,000	
Bank Loan		300,000
Purchases	100,000	
Sales		250,000
Wages	80,000	
Total	**750,000**	**750,000**

Preparing Financial Statements

Step 3a The Income Statement and *Profit & Loss Account*

The Blue Company verified the stocks as of 31st July, and found the following stocks:

Raw Material (cloth)	0
Work-in-Progress (incomplete jeans)	0
Finished Goods (completed jeans)	0

On the basis of the trial balance and the above closing stocks, prepare the income statement and the *profit & loss account* of the Blue Company. Then prepare the balance sheet.

Income Statement of the Blue Company for the Period 1st July to 31st July

	Rupees
Sales	
Expenses:	
Cost of Goods Sold	
Material	
Wages	
Profits	

Profit & Loss Account **for the Period 1st July to 31st July**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Opening Stock			*Sales*	
	Purchases			*Closing Stock*	
	Wages				
	Profits (Bal c/d)				
	Total			**Total**	

Preparing Financial Statements

Step 3a Solution to the Income Statement and *Profit & Loss Account*

Income Statement of the Blue Company for the Period 1st July to 31st July

		Rupees
Sales		250,000
Expenses:		
Cost of Goods Sold		
Material	100,000	
Wages	80,000	
		180,000
Profits		70,000

Profit & Loss Account **for the Period 1st July to 31st July**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Opening Stock	0		*Sales*	250,000
	Purchases	100,000		*Closing Stock*	0
	Wages	80,000			
	Profits (Bal c/d)	70,000			
	Total	250,000		**Total**	250,000

Preparing Financial Statements

Step 3b The Balance Sheet

Balance Sheet of the Blue Company as of 31st July

Building	
Equipment	
Furniture	
Stocks-Raw Material	
Stocks-WIP	
Stocks-Finished Goods	
Debtors	
Cash	
TOTAL ASSETS	
Capital	
Retained Earnings	
Bank Loan	
Creditors	
Accrued Wages	
TOTAL LIABILITIES	

Preparing Financial Statements

Step 3b Solution to the Balance Sheet

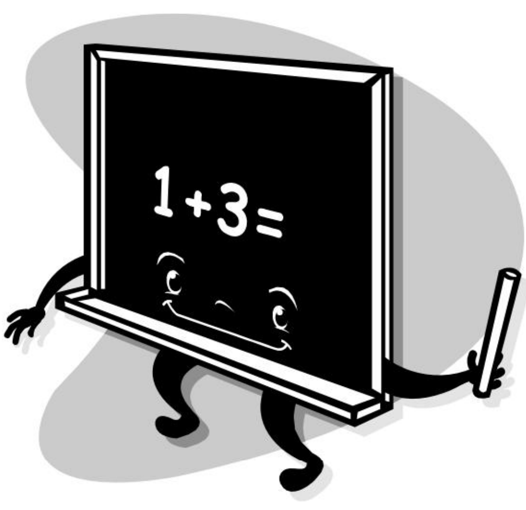
Balance Sheet of the Blue Company as of 31st July

Building	50,000
Equipment	200,000
Furniture	20,000
Stocks-Raw Material	0
Stocks-WIP	0
Stocks-Finished Goods	0
Debtors	0
Cash	300,000
TOTAL ASSETS	**570,000**
Capital	200,000
Retained Earnings	70,000
Bank Loan	300,000
Creditors	0
Accrued Wages	0
TOTAL LIABILITIES	**570,000**

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

12

Complex T-Accounts: Do-It-Yourself



THE BROWN COMPANY

The Brown Company was started in August to manufacture trousers. Each pair of trousers requires Rs. 50 of cloth and Rs. 30 of labour. The transactions of the Brown Company in August are listed below. Enter these in the appropriate T-Accounts provided in the following pages. Be careful, some of the transactions may not need to be entered. Be even more careful, transactions not stated may have to be entered.

Transaction

1st August	T1a	Ramaswamy started the Brown Company, providing Rs. 300,000 as the initial capital.
	T1b	The bank provided a loan of Rs. 400,000 to the Brown Company.
	T1c	The Brown Company bought a building for Rs. 100,000, equipment for Rs. 250,000, and furniture for Rs. 50,000, paying cash.
	T1d	By evening, the Brown Company was all set to start production, and bought Rs. 150,000 worth of cloth, paying cash. This was enough for 3000 pairs of trousers.
5th August	T1e	By this date, work on 2000 pairs of trousers was half-complete.
10th August	T2	The Brown Company completed 1500 pairs of trousers, another 500 were half-complete.
30th August	T3	The Brown Company sold 1000 pairs of trousers for Rs.120,000, on credit.
31st August	T4a	The Brown Company paid Rs. 4,000 to the bank as interest, and Rs. 9,000 as income tax.
	T4b	The Brown Company estimated that the depreciation on fixed assets for August was Rs. 6,000.
	T4c	The Brown Company declared and paid Rs. 15,000 as dividends.

T-Account Recording

Cash **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Capital (Liability)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Building (Asset)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Equipment (Asset)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Furniture (Asset)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Bank Loan (Liability)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Purchases

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Debtors (Asset)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Sales (Income)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Income Tax

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Interest (Expense)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Depreciation (Expense)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Accumulated Depreciation (Liability)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Dividends (Profit Appropriation)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Wages (Expense)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Accrued Wages (Liability)

Debit					Credit
Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Solution to the T-Accounts

The solution is provided below. Now close the T-Accounts.

Cash **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1a	*Capital*	300,000	T1c	*Building*	100,000
T1b	*Bank Loan*	400,000	T1c	*Equipment*	250,000
			T1c	*Furniture*	50,000
			T1d	*Purchases*	150,000
			T4a	*Interest*	4,000
			T4a	*Income Tax*	9,000
			T4c	*Dividends*	15,000
	Total			**Total**	

Capital **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1a	*Cash*	300,000
	Total			**Total**	

Building **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1c	*Cash*	100,000			
	Total			**Total**	

Equipment **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1c	*Cash*	250,000			
	Total			**Total**	

Furniture **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1c	*Cash*	50,000			
	Total			**Total**	

Bank Loan **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T1b	*Cash*	400,000
	Total			**Total**	

Purchases

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T1d	*Cash*	150,000			
	Total			**Total**	

Debtors **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Sales*	120,000			
	Total			**Total**	

Sales **(Income)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			T3	*Debtors*	120,000
	Total			**Total**	

Income Tax

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
T4a	*Cash*	9,000			
	Total			**Total**	

Interest (Expense)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
T4a	*Cash*	4,000			
	Total			**Total**	

Depreciation (Expense)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
T4b	*Accumulated Dep.*	6,000			
	Total			**Total**	

Accumulated Depreciation (Liability)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
			T4b	*Depreciation*	6,000
	Total			**Total**	

Dividends (Profit Appropriation)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
T4c	*Cash*	15,000			
	Total			**Total**	

Wages **(Expense)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
	Accrued Wages	52,500			
	Total			**Total**	

Accrued Wages **(Liability)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
				Wages	52,500
	Total			**Total**	

Preparing Financial Statements

Step 1 Solution to Closing the T-Accounts

Cash **(Asset)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T1a	*Capital*	300,000	T1c	*Building*	100,000
T1b	*Bank Loan*	400,000	T1c	*Equipment*	250,000
			T1c	*Furniture*	50,000
			T1d	*Purchases*	150,000
			T4a	*Interest*	4,000
			T4a	*Income Tax*	9,000
			T4c	*Dividends*	15,000
				Bal c/d	122,000
	Total	700,000		**Total**	700,000
	Bal b/d	122,000			

Capital **(Liability)**

Debit					**Credit**
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
	Bal c/d	300,000	T1a	*Cash*	300,000
	Total	300,000		**Total**	300,000
				Bal b/d	300,000

Building (Asset)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
T1c	*Cash*	100,000		Bal c/d	100,000
	Total	100,000		**Total**	100,000
	Bal b/d	100,000			

Equipment (Asset)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
T1c	*Cash*	250,000		Bal c/d	250,000
	Total	250,000		**Total**	250,000
	Bal b/d	250,000			

Furniture (Asset)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
T1c	*Cash*	50,000		Bal c/d	50,000
	Total	50,000		**Total**	50,000
	Bal b/d	50,000			

Bank Loan (Liability)

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	400,000	T1b	*Cash*	400,000
	Total	400,000		**Total**	400,000
				Bal b/d	400,000

Purchases

Debit | Credit

Ref	Head	Amount	Ref	Head	Amount
T1d	*Cash*	150,000		Bal c/d	150,000
	Total	150,000		**Total**	150,000
	Bal b/d	150,000			

Debtors **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T3	*Sales*	120,000		Bal c/d	120,000
	Total	120,000		**Total**	120,000
	Bal b/d	120,000			

Sales **(Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	120,000	T3	*Debtors*	120,000
	Total	120,000		**Total**	120,000
				Bal b/d	120,000

Income Tax

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4a	*Cash*	9,000		*Bal c/d*	9,000
	Total	9,000		**Total**	9,000
	Bal b/d	9,000			

Interest **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4a	*Cash*	4,000		Bal c/d	4,000
	Total	4,000		**Total**	4,000
	Bal b/d	4,000			

Depreciation **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
T4b	*Accumulated Dep.*	6,000		Bal c/d	6,000
	Total	6,000		**Total**	6,000
	Bal b/d	6,000			

Accumulated Depreciation **(Liability)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
	Bal c/d	6,000	T4b	*Depreciation*	6,000
	Total	6,000		**Total**	6,000
				Bal b/d	6,000

Dividends **(Profit Appropriation)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
T4c	*Cash*	15,000		Bal c/d	15,000
	Total	15,000		**Total**	15,000
	Bal b/d	15,000			

Wages **(Expense)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
	Accrued Wages	52,500		Bal c/d	52,500
	Total	52,500		**Total**	52,500
	Bal b/d	52,500			

Accrued Wages **(Liability)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
	Bal c/d	52,500		*Wages*	52,500
	Total	52,500		**Total**	52,500
				Bal b/d	52,500

Preparing Financial Statements

Step 2 Preparing a Trial Balance

Trial Balance for the Brown Company as of 31st August

	Debit	Credit
Total		

Preparing Financial Statements

Step 2 Solution to the Trial Balance

Trial Balance for the Brown Company as of 31st August

	Debit	Credit
Cash	122,000	
Capital		300,000
Building	100,000	
Equipment	250,000	
Furniture	50,000	
Bank Loan		400,000
Purchases	150,000	
Debtors	120,000	
Sales		120,000
Income Tax	9,000	
Interest	4,000	
Depreciation	6,000	
Accumulated Depreciation		6,000
Dividends	15,000	
Wages	52,500	
Accrued Wages		52,500
Total	**878,500**	**878,500**

Preparing Financial Statements

Step 3a The Income Statement and *Profit & Loss Account*

The Brown Company verified the stocks as of 31st August, and found the following stocks:

Raw Material (cloth)	50,000
Work-in-Progress (incomplete jeans)	32,500
Finished Goods (completed jeans)	40,000

On the basis of the trial balance and the above closing stocks, prepare the income statement and the *profit & loss account* of the Brown Company. Then prepare the balance sheet.

Income Statement of the Brown Company for the Period 1st August to 31st August

	Rupees
Sales	
Expenses:	
Cost of Goods Sold	
Material	
Wages	
Depreciation	
Interest	
Profit Before Tax	
Income Tax	
Profit After Tax	
Allocation of Profits	
Dividends	
Retained Earnings	

Profit & Loss Account **for the Period 1st August to 31st August**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Total			Total	

Preparing Financial Statements

Step 3a Solution to the Income Statement and *Profit & Loss Account*

Income Statement of The Brown Company for the Period
1st August To 31st August

		Rupees
Sales		120,000
Expenses:		
Cost of Goods Sold		
Material	50,000	
Wages	30,000	80,000
Depreciation		6,000
Interest		4,000
Profit Before Tax		30,000
Income Tax		9,000
Profit After Tax		21,000
Allocation of Profits		
Dividends		15,000
Retained Earnings		6,000

***Profit & Loss Account* for the Period 1st August to 31st August**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Opening Stock	0		*Sales*	120,000
	Purchases	150,000		*Closing Stock**	122,500
	Wages	52,500			
	Interest	4,000			
	Depreciation	6,000			
	Income Tax	9,000			
	Dividends	15,000			
	Bal c/d	6,000			
	Total	242,500		**Total**	242,500

*Closing stock comprises stocks of raw material, WIP, and finished goods.

Preparing Financial Statements

Step 3b The Balance Sheet

Balance Sheet of the Brown Company as of 31st August

Building *Equipment* *Furniture* Gross Fixed Assets Less: *Accumulated Depreciation* Net Fixed Assets *Stocks–Raw Material* *Stocks–WIP* *Stocks–Finished Goods* *Debtors* *Cash*	
TOTAL ASSETS	
Capital *Retained Earnings* *Bank Loan* *Accrued Wages*	
TOTAL LIABILITIES	

Preparing Financial Statements

Step 3b Solution to the Balance Sheet

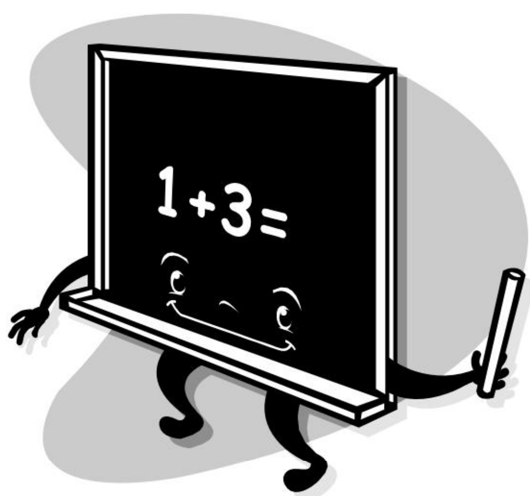
Balance Sheet of the Brown Company as of 31st August

Building	100,000
Equipment	250,000
Furniture	50,000
Gross Fixed Assets	*400,000*
Less: *Accumulated Depreciation*	6,000
Net Fixed Assets	*394,000*
Stocks-Raw Material	50,000
Stocks-WIP	32,500
Stocks-Finished Goods	40,000
Debtors	120,000
Cash	122,000
TOTAL ASSETS	**758,500**
Capital	300,000
Retained Earnings	6,000
Bank Loan	400,000
Accrued Wages	52,500
TOTAL LIABILITIES	**758,500**

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

CHAPTER 13

Accounting Systems: Cash Book, Journal and Ledgers



Until now we had concentrated on T-Accounts, omitting other aspects of formal accounting systems. Also we had moved magically from the trial balance to the income statement. We will now redo the Brown Company, including all those formal aspects that we had ignored so far. We will guide you through the formal accounting process from the beginning till the preparation of financial statements.

This is the sequence that we will follow:

Step	
1	Initiating Transactions
2	Recording Transactions Chronologically
3	Adjustment Entries
4	Recording Transactions in T-Accounts
5	Initial Trial Balance
6	Preparation of the *Profit & Loss Account* and Closing of T-Accounts
7	Preparation of the Balance Sheet

Step 1 Initiating Transactions

An accounting transaction is initiated by a source document. No sane accountant will ever record a transaction unless it is formally supported by some documentary evidence. These documents, in fact, authorize the recording of the transactions and also provide the auditors of the accounts with the necessary evidence. For example, the source document for a purchase transaction is a bill raised by the seller on the buying company and authorised by someone designated in the buying organisation. Similarly, for all cash payments there will be a 'cash voucher' containing transaction details (such as the name of the recipient, the purpose of the payment, the account heads affected, the date, the amount and the authorisation for the payment).

Step 2 Recording Transactions Chronologically

The transactions of the Brown Company are listed below.

1st August	T1a	Ramaswamy started the Brown Company, providing Rs. 300,000 as the initial capital.
	T1b	The bank provided a loan of Rs. 400,000 to the Brown Company.
	T1c	The Brown Company bought a building for Rs. 100,000, equipment for Rs. 250,000, and furniture for Rs. 50,000, paying cash.
	T1d	By evening, the Brown Company was all set to start production, and bought Rs. 150,000 worth of cloth, paying cash. This was enough for 3000 pairs of trousers.

5th August	T1e	By this date, work on 2000 pairs of trousers was half-complete.
10th August	T2	The Brown Company completed 1500 pairs of trousers, another 500 were half-complete.
30th August	T3	The Brown Company sold 1000 pairs of trousers for Rs.120,000, on credit.
31st August	T4a	The Brown Company paid Rs. 4,000 to the bank as interest, and Rs. 9,000 as income tax.
	T4b	The Brown Company estimated that the depreciation on fixed assets for August was Rs. 6,000.
	T4c	The Brown Company declared and paid Rs. 15,000 as dividends.

On 31st August, the Brown Company valued its stocks (raw material Rs. 50,000, WIP Rs. 32,500 and finished goods Rs. 40,000).

The above transactions have to be recorded. An organisation maintains a chronological record of transactions essentially to ensure that all financial transactions are recorded in one place to begin with. If all transactions were in cash, the *cash* T-Account could have served this purpose as well. As organisations have non-cash transactions, for example transaction T3, a record called Journal is maintained. Hence, every financial transaction is recorded either in the Cash Book (cash transactions) or in the Journal (non-cash transactions).

We will record all cash transactions T1a, T1b, T1c, T1d, T4a, and T4c in the *cash* T-Account, which is now called the Cash Book. The Cash Book contains two types of information. First, it contains a chronological record of all cash transactions. Second, it provides us the cash balance at any point in time. Every entry has a running Cash Book serial number (C1, C2, and so on) that will be used as a cross-reference in the T-Accounts. T-Accounts are formally called ledgers.

Cash

Debit **Credit**

Aug	**Ref**	**Head**		**Amount**	**Aug**	**Ref**	**Head**		**Amount**
1	C1	*Capital*	[T1a]	300,000	1	C3	*Building*	[T1c]	100,000
1	C2	*Bank Loan*	[T1b]	400,000			*Equipment*	[T1c]	250,000
							Furniture	[T1c]	50,000
					1	C4	*Purchases*	[T1d]	150,000
					31	C5	*Interest*	[T4a]	4,000
						C6	*Income tax*	[T4a]	9,000
						C7	*Dividend*	[T4c]	15,000
							Bal c/d		122,000
			Total	700,000				**Total**	700,000
	Bal b/d			122,000					

Now that we have recorded all cash transactions in the Cash Book, transaction T3 that does not involve cash will be recorded in the Journal.

Journal

Date	Sl. No.	Accounts	L.F.	Debit	Credit
Aug-30	J1	*Debtors*		120,000	
		Sales			120,000

The Journal records both the debit and credit sides of a transaction. The Ledger Folio (L.F.) provides a cross-reference to the ledger account with page numbers. By convention the first account (in this case *debtors*) is debited, and the second account (in this case *sales*) is credited.

The transactions recorded so far are those that are always recorded as and when they occur. Other transactions are recorded only at the time of closing of accounts in preparation for producing financial statements. Examples of these are the entry for depreciation (transaction T4b), and accrued wages (transaction T2). We will handle them in Step 3 that follows.

Step 3 Adjustment Entries

While the transactions recorded in Step 2 are those that are usually recorded as and when they occur, there are other transactions (such as depreciation and accrued wages) that are recorded only at the time of preparation of financial statements. For instance, an organisation would find it terribly wasteful to compute and account for depreciation on a daily basis, although the assets are being used daily. There are a number of such items that are recorded only at the time of preparation of financial statements. Transactions T4b and T2 of the Brown Company are recorded in the journal below.

Journal

Date	Sl. No.	Accounts	L.F.	Debit	Credit
Aug-31	J2	*Depreciation*		6,000	
		Accumulated Depreciation			6,000
	J3	*Wages*		52,500	
		Accrued Wages			52,500

Step 4 Recording Transactions in T-Accounts

T-Accounts are formally called ledger accounts. We will post the transactions recorded in the Cash Book and Journal in Steps 2 and 3, in the corresponding ledger accounts.

Capital **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			C1	*Cash*	300,000
	Total			**Total**	

Bank Loan **(Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
			C2	*Cash*	400,000
	Total			**Total**	

Building **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
C3	*Cash*	100,000			
	Total			**Total**	

Equipment **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
C3	*Cash*	250,000			
	Total			**Total**	

Furniture **(Asset)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
C3	*Cash*	50,000			
	Total			**Total**	

Purchases

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
C4	*Cash*	150,000			
	Total			**Total**	

***Interest* (Expense)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
C5	*Cash*	4,000			
	Total			**Total**	

Income Tax

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
C6	*Cash*	9,000			
	Total			**Total**	

***Dividends* (P&L Appropriation)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
C7	*Cash*	15,000			
	Total			**Total**	

***Debtors* (Asset)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
J1	*Sales*	120,000			
	Total			**Total**	

***Sales* (Income)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
			J1	*Debtors*	120,000
	Total			**Total**	

***Depreciation* (Expense)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
J2	*Accumulated Depreciation*	6,000			
	Total			**Total**	

***Accumulated Depreciation* (Liability)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
			J2	*Depreciation*	6,000
	Total			**Total**	

***Wages* (Expense)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
J3	*Accrued Wages*	52,500			
	Total			**Total**	

***Accrued Wages* (Liability)**

Debit					Credit
Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
			J3	*Wages*	52,500
	Total			**Total**	

Step 5 Initial Trial Balance

At this stage a trial balance can be drawn to verify the arithmetical accuracy. We suggest that you prepare one following the detailed steps in chapter twelve. However, we are providing the trial balance below.

Initial Trial Balance for the Brown Company as of 31st August

	Debit	Credit
Cash	122,000	
Capital		300,000
Bank Loan		400,000
Building	100,000	
Equipment	250,000	
Furniture	50,000	
Purchases	150,000	
Interest	4,000	
Income Tax	9,000	
Dividends	15,000	
Debtors	120,000	
Sales		120,000
Depreciation	6,000	
Accumulated Depr.		6,000
Wages	52,500	
Accrued Wages		52,500
Total	**878,500**	**878,500**

Step 6 Preparation of *Profit & Loss Account* and Closing of T-Accounts

We will now prepare the *profit & loss* (*P&L*) account. To do this we will transfer the balances of all revenue and expense related T-Accounts to the *P&L* Account, by recording appropriate journal entries. As a result of this step, all revenue and expense related T-Accounts will be closed. But T-Accounts related to assets and liabilities will not be closed and will have balances that will be reflected in the balance sheet.

The value of closing stock has to be reflected in financial statements both to estimate the cost of goods sold, and to show stock values on the asset side of the balance sheet. Suitable journal entries will be made to take care of this.

The detailed journal entries are shown below.

Journal

Date	Sl. No.	Accounts	L.F.	Debit	Credit
Aug-31					
	J4	*Stocks–Raw Material*		50,000	
		P&L			50,000
	J5	*Stocks–WIP*		32,500	
		P&L			32,500
	J6	*Stocks–Finished Goods*		40,000	
		P&L			40,000
	J7	*P&L*		150,000	
		Purchases			150,000
	J8	*P&L*		4,000	
		Interest			4,000
	J9	*P&L*		9,000	
		Income Tax			9,000
	J10	*Sales*		120,000	
		P&L			120,000
	J11	*P&L*		6,000	
		Depreciation			6,000
	J12	*P&L*		52,500	
		Wages			52,500

The above journal entries have been posted in the corresponding ledger accounts below, which have then been closed. As we had stated, all revenue and expense related ledger accounts are closed by transfer of their balances to the *P&L Account*. Journal entries J4 to J6 ensure that all stocks are reflected on the balance sheet, and along with journal entry J7 ensure that cost of goods sold is correctly reflected in the *P&L* account.

You may note that all asset and liability related ledger accounts have balance brought down (bal b/d). You will also note that the *dividend* account has not been closed here. We shall handle this later.

***Capital* (Liability)**

Debit | **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	300,000	C1	*Cash*	300,000
	Total	300,000		**Total**	300,000
				Bal b/d	300,000

Bank Loan **(Liability)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
	Bal c/d	400,000	C2	*Cash*	400,000
	Total	400,000		**Total**	400,000
				Bal b/d	400,000

Building **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
C3	*Cash*	100,000		Bal c/d	100,000
	Total	100,000		**Total**	100,000
	Bal b/d	100,000			

Equipment **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
C3	*Cash*	250,000		Bal c/d	250,000
	Total	250,000		**Total**	250,000
	Bal b/d	250,000			

Furniture **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
C3	*Cash*	50,000		Bal c/d	50,000
	Total	50,000		**Total**	50,000
	Bal b/d	50,000			

Purchases

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
C4	*Cash*	150,000	J7	*P&L*	150,000
	Total	150,000		**Total**	150,000

Interest **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
C5	*Cash*	4,000	J8	*P&L*	4,000
	Total	4,000		**Total**	4,000

Income Tax

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
C6	*Cash*	9,000	J9	*P&L*	9,000
	Total	9,000		**Total**	9,000

Dividends **(P&L Appropriation)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
C7	*Cash*	15,000			
	Total			**Total**	

Debtors **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
J1	*Sales*	120,000		Bal c/d	120,000
	Total	120,000		**Total**	120,000
	Bal b/d	120,000			

Sales **(Income)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
J10	*P&L*	120,000	J1	*Debtors*	120,000
	Total	120,000		**Total**	120,000

Depreciation **(Expense)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
J2	*Accumulated Depreciation*	6,000	J11	*P&L*	6,000
	Total	6,000		**Total**	6,000

Accumulated Depreciation **(Liability)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
	Bal c/d	6,000	J2	*Depreciation*	6,000
	Total	6,000	**Total**	6,000	
				Bal b/d	6,000

Wages **(Expense)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
J3	*Accrued Wages*	52,500	J12	*P&L*	52,500
	Total	52,500		**Total**	52,500

Accrued Wages **(Liability)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
	Bal c/d	52,500	J3	*Wages*	52,500
	Total	52,500		**Total**	52,500
			Bal b/d	52,500	

Stocks–Raw Material **(Asset)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
J4	*P&L*	50,000		Bal c/d	50,000
	Total	50,000		**Total**	50,000
	Bal b/d	50,000			

Stocks–WIP **(Asset)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
J5	*P&L*	32,500		Bal c/d	32,500
	Total	32,500		**Total**	32,500
	Bal b/d	32,500			

Stocks–Finished Goods **(Asset)**

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
J6	*P&L*	40,000		Bal c/d	40,000
	Total	40,000		**Total**	40,000
	Bal b/d	40,000			

Profit & Loss Account

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
J7	*Purchases*	150,000	J10	*Sales*	120,000
J12	*Wages*	52,500	J4	*Stocks–Raw Material*	50,000
J11	*Depreciation*	6,000	J5	*Stocks–WIP*	32,500
J8	*Interest*	4,000	J6	*Stocks–Finished Goods*	40,000
J9	*Income Tax*	9,000			
	Profits	21,000			
	Total	242,500		**Total**	242,500

You will recollect that the balance sheet shows retained earnings. The *P&L* account shows the profits made in a period. These profits may be partly/fully paid out as dividends with the balance earnings retained. To facilitate this we need a *P&L appropriation* account. The following entries lead to the preparation of the *P&L appropriation* account, which reflects dividend, and retention amounts. We need the following journal entries:

Journal

Date	Sl. No.	Accounts	L.F.	Debit	Credit
Aug-31	J13	*P&L*		21,000	
		P&L Appropriation			21,000
	J14	*P&L Appropriation*		15,000	
		Dividend			15,000
	J15	*P&L Appropriation*		6,000	
		Retained Earnings			6,000

These journal entries are posted in the respective accounts below.

Profit & Loss Account

Debit **Credit**

Ref	Head	Amount	Ref	Head	Amount
J7	*Purchases*	150,000	J10	*Sales*	120,000
J12	*Wages*	52,500	J4	*Stocks–Raw Material*	50,000
J11	*Depreciation*	6,000			

(Contd)

(Contd)

J8	*Interest*	4,000	J5	*Stocks–WIP*	32,500
J9	*Income Tax*	9,000	J6	*Stocks–Finished Goods*	40,000
J13	*P&L Appropriation*	21,000			
	Total	242,500		**Total**	242,500

P&L Appropriation Account

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
J14	*Dividends*	15,000	J13	*P&L*	21,000
J15	*Retained Earnings*	6,000			
	Total	21,000		**Total**	21,000

***Dividends* (P&L Appropriation)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
C7	*Cash*	15,000	J14	*P&L Appropriation*	15,000
	Total	15,000		**Total**	15,000

***Retained Earnings* (Liability)**

Debit **Credit**

Ref	**Head**	**Amount**	**Ref**	**Head**	**Amount**
	Bal c/d	6,000	J15	*P&L Appropriation*	6,000
	Total	6,000		**Total**	6,000
			Bal b/d		6,000

Step 7 Preparation of the Balance Sheet

In order to prepare the balance sheet, we draw the final trial balance. Items from this trial balance will go only to the balance sheet. You will recollect that all revenue and expense ledger accounts have been closed by transfer to the *profit and loss account*. In turn the balance in the *profit & loss account* has been closed by transfer to the *profit & loss appropriation account*. Then the balance in the *profit & loss appropriation account*, in turn, has been closed by transfer to the *retained earnings* account.

Final Trial Balance for the Brown Company as of 31st August

	Debit	Credit
Cash	122,000	
Capital		300,000
Bank Loan		400,000
Building	100,000	
Equipment	250,000	
Furniture	50,000	
Debtors	120,000	
Accumulated Depreciation		6,000
Accrued Wages		52,500
Stocks–Raw Material	50,000	
Stocks–WIP	32,500	
Stocks–Finished Goods	40,000	
Retained Earnings		6,000
Total	**764,500**	**764,500**

Note that the Cash Book also serves the purpose of a ledger account. This trial balance is used to prepare the balance sheet below. This balance sheet is identical to the one in chapter 12.

Balance Sheet of the Brown Company as of 31st August

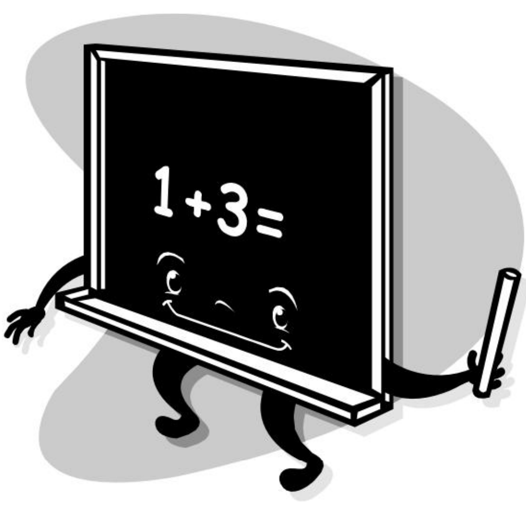
Building	100,000
Equipment	250,000
Furniture	50,000
Gross Fixed Assets	*400,000*
Less: *Accumulated Depreciation*	6,000
Net Fixed Assets	*394,000*
Stocks–Raw Material	50,000
Stocks–WIP	32,500
Stocks–Finished Goods	40,000
Debtors	120,000
Cash	122,000
TOTAL ASSETS	**758,500**
Capital	300,000
Retained Earnings	6,000
Bank Loan	400,000
Accrued Wages	52,500
TOTAL LIABILITIES	**758,500**

You may observe that the entire process of the recording of the financial transactions—from tracing them from the source document down to the preparation of the income statement and balance sheet—follows systematic steps and does not leave anything to chance or imagination.

THIS EXERCISE ENDS HERE. SEE YOU TOMORROW !!!

CHAPTER 14

Learning from Accounting Scams



A word of caution: We are basically honest people and we are sure that you conform to the highest standards of integrity. So why this chapter? Because the world outside is peopled with a small minority of dishonest humans, sadly often in positions of power, and it is important for you to understand what they can do in the context of accounting. The most common unethical (and sometimes criminal) act is to manipulate financial statements to show superior performance. We will use Brown Company (see Chapter 12) to show some of the games dishonest people can play.

GAME 1: ANTICIPATING SALES

A company has some unsold stock of finished goods at year-end. There is a temptation to show part of the stock of finished goods as sales, and book the corresponding profit. Overstating profits can help companies manipulate stock prices. In some cases, over-statement of profits can help managers earn better bonuses as their compensation may be linked to either reported profit or stock prices.

What happens if the Brown Company were to show half the stock of finished goods as on 31st August as sales? Compute the impact on the income statement and balance sheet.

First list the income statement and balance sheet items that will be affected by this scam. Then fill up the amounts.

WE HAVE LISTED THE INCOME STATEMENT AND BALANCE SHEET ITEMS BELOW– DON'T PEEK.

Income Statement Items Affected by Scam [Rs.]

Sales	
Cost of Goods Sold	
Profit Before Tax	
Income Tax	
Profit after Tax	
Retained Earnings	

Balance Sheet Items Affected by Scam [Rs.]

Stock-Finished Goods	
Debtors	
Cash	
TOTAL ASSETS	
Retained Earnings	
TOTAL LIABILITIES	

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Game I Solution: Income Statement

The Brown Company actually had 500 pairs of finished trousers in *Stock-Finished Goods* as of 31st August. If 250 pairs (half the stock) are treated as sold, *Sales* will go up by Rs. 30,000 (250 pairs of trousers at Rs. 120 per pair sale price), and *Cost of Goods Sold* will increase by Rs. 20,000 (250 trousers at Rs. 80 per pair). Hence, *Profit Before Tax* will increase by Rs. 10,000 (Rs. 30,000 minus Rs. 20,000). *Income Tax* of Rs. 3,000 (30% of Rs. 10,000) will have to be paid on this additional profit shown. *Profit After Tax* and *Retained Earnings* will increase by Rs. 7,000 (Rs. 10,000 minus Rs. 3,000).

Game I Solution: Balance Sheet

Stock-Finished Goods will reduce by Rs. 20,000 (250 pairs of trousers at Rs. 80 per pair material and labour cost). *Debtors* will increase by the additional sales of Rs. 30,000. The *Cash* balance will reduce by Rs. 3,000 (reflecting the additional income tax paid). As a consequence, **TOTAL ASSETS** will increase by Rs. 7,000. *Retained Earnings* will increase by Rs. 7,000, and **TOTAL LIABILITIES** will also increase by this amount.

The net result, Brown Company appears to be more profitable. Warning signals are lean inventories and debtors that will be settled slowly since strictly no one actually owes this amount to the Brown Company; and lower cash balances since taxes on non-existent profits have to be paid. Often such pseudo-sales are effected by pushing inventory down the throats of wholesalers in the retail chain.

An American company Computer Associates was accused of misstating more than $500 million in revenue in its 1998 and 1999 fiscal years in order to artificially inflate its stock price. The US Securities and Exchange Commission alleged that from 1998 to 2000, Computer Associates included quarterly revenue from contracts executed after the quarter ended in an attempt to meet analysts' expectations.

GAME 2: CAPITALISING EXPENSES

This is child's play. Part of the true expenses are not reported as expenses but are capitalised (i.e. treated as assets). Not recording expenses incurred as expenses, and recording them as assets leads to under-stating the expenses, over-stating the assets and inflating profits. .

Suppose Brown Company managed to capitalise Rs. 10,000 of the cost of goods sold and show this amount as equipment.

Suppose Brown Company did not play Game 1. What happens if the Brown Company instead managed to capitalise Rs. 10,000 of the *Cost of Goods Sold* and show this amount as *Equipment.* Compute the impact on the income statement and balance sheet. To simplify the problem, assume that the *Depreciation* expense remains at Rs. 6,000 as before.

First list the income statement and balance sheet items that will be affected by this scam. Then fill up the amounts.

WE HAVE LISTED THE INCOME STATEMENT AND BALANCE SHEET ITEMS BELOW– DON'T PEEK.

Income Statement Items Affected by Scam [Rs.]

Cost of Goods Sold	
Profit Before Tax	
Income Tax	
Profit after Tax	
Retained Earnings	

Balance Sheet Items Affected by Scam [Rs.]

Equipment	
Gross Fixed Assets	
Net Fixed Assets	
Cash	
TOTAL ASSETS	
Retained Earnings	
TOTAL LIABILITIES	

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Game 2 Solution: Income Statement

Cost of Goods Sold will reduce by Rs. 10,000. As with Game 1, *Profit Before Tax* will increase by this Rs. 10,000. *Income Tax* of Rs. 3,000 (30% of Rs. 10,000) will have to be paid on this additional profit shown. *Profit After Tax* and *Retained Earnings* will both increase by Rs. 7,000.

Game 2 Solution: Balance Sheet

Equipment, Gross Fixed Assets and Net Fixed Assets will increase by Rs. 10,000. The *Cash* balance will reduce by Rs. 3,000 (reflecting the additional income tax paid). As a consequence, **TOTAL ASSETS** will increase by Rs.7,000. *Retained Earnings* will increase by Rs. 7,000, and **TOTAL LIABILITIES** will also increase by this amount.

The net result, Brown Company appears to be more profitable. Warning signals are seeming over-efficiency in terms of operations since the cost of goods sold is low compared to sales, combined with seeming under-efficiency in terms of fixed asset productivity since sales are low compared to the amount of fixed assets used; and lower cash balances since taxes on non-existent profits have to be paid.

WorldCom was alleged to have capitalised line costs–interconnection expenses with other telecommunication companies–although these are truly expenses. By the end of 2003, it was estimated that the company's total assets had been inflated by around $11 billion. Obviously one problem is paying income tax. WorldCom resolved this by managing to show US $17 billion profits to shareholders but only US $1 billion to the income tax guys! Note that no scam is usually of the pure type and WorldCom played a number of games, although Game 2 predominated.

GAME 3: IMAGINARY PRODUCTION AND SALES

This is a tougher game to sustain. Unlike Game 1 (where manufactured goods were shown as sold), in this game manufacturing itself is cooked-up–so one has fictitious purchases, fictitious material consumption and labour, possibly fictitious other expenses, culminating in fictitious sales.

Suppose the Brown Company did not play Game 1 or Game 2 but instead chose to show 250 pairs of trousers that were never produced as sold. Logically, it has to show purchase and consumption of fictitious raw material, as well as use of fictitious labour. Compute the impact on the income statement and balance sheet. Simplify the problem by assuming that fictitious raw material is reported as procured exactly for 250 pairs of trousers (and corresponding fictitious labour is reported as used). This simplification means that there are no changes in *Stocks-Raw Material* and *Stocks-Work-in-Progress.* Also assume that no dues for purchase of fictitious raw material or fictitious wages will be shown in the balance sheet.

First list the income statement and balance sheet items that will be affected by this scam. Then fill up the amounts.

WE HAVE LISTED THE INCOME STATEMENT AND BALANCE SHEET ITEMS BELOW– DON'T PEEK.

Income Statement Items Affected by Scam [Rs.]

Sales	
Cost of Goods Sold	
Profit Before Tax	
Income Tax	
Profit after Tax	
Retained Earnings	

Balance Sheet Items Affected by Scam [Rs.]

Stock-Finished Goods	
Debtors	
Cash	
TOTAL ASSETS	
Retained Earnings	
TOTAL LIABILITIES	

Stop

Do not turn over this page till you have given it some thought.

Turn over this page for the solution.

Game 3 Solution: Income Statement

Sales will go up by Rs. 30,000 (250 pairs of trousers at Rs. 120 per pair sale price), and *Cost of Goods Sold* will increase by Rs. 20,000 (250 trousers at Rs. 80 per pair). Hence, *Profit Before Tax* will increase by Rs. 10,000 (Rs. 30,000 minus Rs. 20,000). *Income Tax* of Rs. 3,000 (30% of Rs. 10,000) will have to be paid on this additional profit shown. *Profit After Tax* and *Retained Earnings* will both increase by Rs. 7,000 (Rs. 10,000 minus Rs. 3,000).

Game 3 Solution: Balance Sheet

Retained Earnings will increase by Rs. 7,000, and **TOTAL LIABILITIES** will also increase by this amount. The *Cash* balance will reduce by Rs. 3,000 (reflecting the additional income tax paid). **TOTAL ASSETS** need to increase by Rs. 7,000. This is possible if *Debtors* are overstated by Rs. 10,000.

The net result, Brown Company appears to be more profitable. Warning signals are high capacity utilisation and debtors that will be settled slowly since strictly no one owes this amount to the Brown Company; and lower cash balances since taxes on non-existent profits have to be paid.

Tri-Sure India Ltd. allegedly played Game 3 in the 1970s before a public issue. However, one consequence of this episode is that a High Court held that "auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud when there is nothing to arouse their suspicion and when these frauds are perpetrated by the tried servants of the company and are undetected for years by the directors." This basically means that if the company is clever enough, the auditors are off the hook. We suggest you read this chapter several times so that you can see through such financial statements.

GAME 4 COMPLEX CORPORATE STRUCTURE

In this game, numerous inter-connected companies are set up, giving management an opportunity to move both profits and cash through a maze that is difficult to track. So complicated is this, in fact, that we cannot use our simple Brown Company to illustrate this.

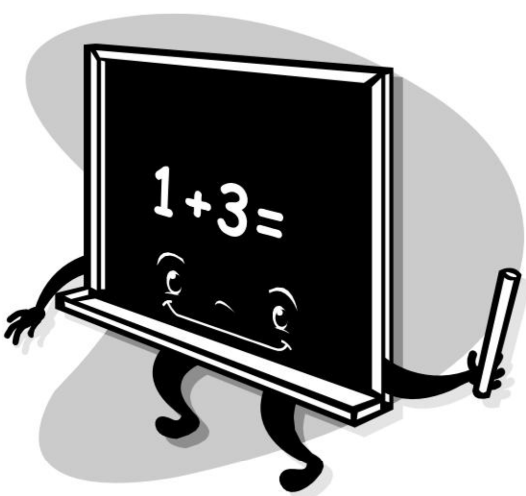
A classic real-life player of Game 4 was Enron. Enron created a large number of "offshore" special purpose entities, ostensibly for tax planning. Actually, however these facilitated currency movements and allowed management to push losses into anonymous entities, thereby allowing the publicly traded Enron to show artificial profits. This boosted share prices, and insiders took full advantage of artificially high share prices to make money. Enron was indicted for a range of financial crimes including "bank fraud, making false statements to banks and auditors, securities fraud, wire fraud, money laundering, conspiracy and insider trading."

GAME 5: THE SATYAM GAME

Frankly we do not know what happened and we are not alone in this ignorance. Hopefully, the next edition will have more information about this game.

CHAPTER 15

Accounting Concepts and Policy



With your newly acquired familiarity with accounting, you are now in a position to appreciate the concepts and policies that it is based on.

CONCEPTS

Concepts are guidelines used by accountants in the preparation of financial statements. We will first look at concepts used in the preparation of the balance sheet and then at concepts used in the preparation of the income statement.

Concepts: Balance Sheet

1. Entity Concept

Accounting is carried out for a given entity, as distinct from its promoters. For example accounting was carried out and financial statements prepared for the Green Company as an entity. However, we made a clear distinction between the transactions of the Green Company and those of its promoter, Ramaswamy. Recall that the very first transaction of the Green Company showed the capital contributed by Ramaswamy as a liability of the Green Company to Ramaswamy.

2. Going Concern Concept

When we prepared the balance sheet of the Brown Company as of August 31, we valued stocks–WIP at Rs. 32,500, which represented the cost of material and wages attributable to this stock. If the Brown Company had gone broke on September 1 then this stock would possibly realize much less than Rs. 32,500, maybe even zero. Our valuation used the Going Concern Concept. At the time of preparing a balance sheet it is assumed that the entity would continue to operate normally in the future. Therefore, stocks are reported on the balance sheet at cost.

3. Monetary Concept

The Green Company's balance sheet reported whatever was objectively measurable in money terms. Ramaswamy's managerial skills were not valued and shown as an asset on the balance sheet.

4. Historical Cost Concept

The Green Company recorded the building at the purchase price of Rs. 25,000 on April 3. Rs. 25,000 was a reasonable price for this building on that date. Suppose the price of such a building appreciated sharply to Rs. 50,000 on April 5. By the Historical Cost Concept, the Green Company would continue to report the building gross value at Rs. 25,000 and not at Rs. 50,000.

5. Accounting Equivalence Concept

We have throughout used the Accounting Equivalence concept that ASSETS = LIABILITIES. Liabilities represent funds *owed* by the entity. Assets represent funds *owned* by the entity. The balance sheet prepared at any point in time reflects that total funds *owed* are equal to total funds *owned*.

Concepts: Income Statement

6. Accounting Period Concept

The income statement is always prepared for a specified accounting period. Its central purpose is to show the profits made in that specified period. Profits represent the difference between revenues and expenses. The subsequent concepts clarify what revenue is and what an expense is.

7. Conservatism Concept

The Conservatism Concept determines when profits are recognized.

The Brown Company has stocks-raw materials of Rs. 50,000 on August 31. Suppose the market value of these stocks was Rs. 70,000 on that date, what value would you assign to these stocks on the balance sheet of that date?

You are right; you will assign Rs. 50,000 based on the Historical Cost Concept. Now try this. Suppose the market value of these stocks was Rs. 40,000 on that date, what value would you assign to these stocks on the balance sheet of that date?

If you have still guessed Rs. 50,000, you are wrong. Conservatism requires you to value stocks–raw material at Rs. 40,000. As a result of this conservative revaluation of the closing stock, the cost of goods sold will increase by Rs. 10,000 [Rs. 50,000-Rs. 40,000] and the profits will decrease by Rs. 10,000.

This illustrates the general pessimistic attitude of accountants. Profits are only recognized if they are reasonably sure. Losses, on the other hand, are recognized even if they think there is a possibility.

8. Realization Concept

The Realization Concept determines the amount of revenue to be recognized. The simple rule is that the amount recognized as revenue is the amount that is reasonably certain to be ultimately collected as cash.

Conservatism and Realization Concepts go hand in hand, as illustrated in Blue Company. Should revenue be recognized when the Blue Company obtained an order from the government, when it completed production of the jeans ordered, when it delivered jeans to the government, or when the government paid up?

When it receives the order there is uncertainty about producing jeans in the first place, and having them accepted by the government. It is premature to recognize revenue at this stage.

When it completes the jeans there is still uncertainty about whether the government would accept them. It is still a little too early to recognize revenue.

When it delivers the jeans on July 24 and the government accepts the delivery, there is a reasonable certainty that the government will pay, and pay in full. This reasonable certainty that the government will pay implies that the Conservatism Concept can be invoked and revenue recognized on July 24 itself.

The reasonable certainty that government will pay Rs. 250,000 implies that the Realization Concept can be invoked and an amount of Rs. 250,000 recognized as revenue on July 24 itself.

9. Matching Concept

Having recognized revenue as above, the Matching Concept specifies how expenses should be recognized. Broadly this concept specifies that all expenses related to the revenue recognized for an accounting period should be reflected in the income statement.

We will use the Brown Company to illustrate this concept. Expenses fall in two categories. The first is product-related, such as material and labour. Every pair of trousers produced consumes Rs. 50 worth material and Rs. 30 worth labour. So against revenue of Rs. 120,000 from the sale of 1000 pairs of trousers, we recognize a total of Rs. 80,000 as material and labour expenses. The remaining amounts incurred on material and labour are reflected in the closing stock values (raw material, WIP, and finished goods) and hence not included as expense for August. These amounts were not incurred to earn the revenue of Rs. 120,000 and cannot be included as expenses.

The second category of expenses is period related, such as interest expense. Interest of Rs. 4,000 will be incurred in the period August 1 to August 31, irrespective of the number of pairs of trousers produced. The entire Rs. 4,000 will be shown as an expense for the period August 1 to August 31.

Accounting Policies

The concepts provide a broad framework for the preparation of financial statements. However, each entity needs to define a set of accounting policies consistent with the nature of its business. These policies provide clear guidelines for revenue recognition, inventory valuation, fixed asset valuation, depreciation of fixed assets, and so on. We will deal with three items here.

1. Revenue Recognition

The policy on revenue recognition provides guidelines with respect to the timing and the amount of revenue to be recognized. In this sense, the policy of revenue recognition essentially depends on the concept of conservatism and realization discussed above.

The most standard time of revenue recognition is at the time of delivery of goods. Here it is assumed that there is reasonable certainty about collection of cash. All our exercises are based on this assumption.

Applying this policy to the preparation of income statement of a builder of residential block of flats may create problems. If, like a typical builder, he completes the entire block in two years, this policy would mean all revenues would be recognized only in the second year. No revenues will be recognized in the first year, even though a lot of effort might have gone into the first year. However, the policy on Revenue Recognition would provide for an option of recognition of revenue on the basis of percentage of work completed in the first year. For example, if 40 per cent of the work were completed in the first year, the percent completion method would permit recognition of 40 per cent of the revenue in the first year.

2. Inventory Valuation

By this time you would have realized that valuation of closing stocks (inventory) is important in determining the cost of goods sold and hence the profits of an entity.

Inventories can be valued using several methods. The common ones that are used are: weighted average method, First-In-First-Out [FIFO] or Last-In-First-Out [LIFO]. These methods are not elaborated here.

3. Fixed Assets and Depreciation

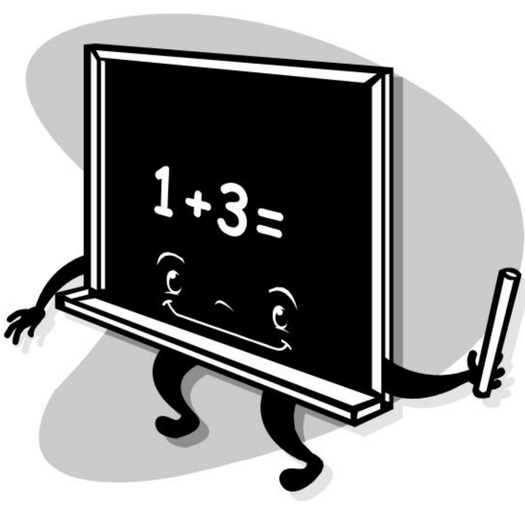
Suppose a company acquires a personal computer for Rs. 50,000. It then pays Rs. 1,000 to a transport company for delivery. Finally, it spends another Rs. 3,000 on installation. Now the computer is ready for use. The company will show the cost of this computer on the balance sheet at Rs. 54,000. In other words, fixed assets are recorded at the cost incurred to make the asset usable.

Suppose that this computer has a useful life of three years to the company in the sense that it will help generate revenues for three years. The matching concept requires that the entire Rs. 54,000 cannot be treated as an expense in the first year. This Rs. 54,000 has to be written off (charged as an expense) as depreciation over this three year period.

One policy is to use straight-line depreciation and show Rs. 18,000 as depreciation expense in each of the three years. Apart from this straight-line depreciation method, there are several other methods.

CHAPTER 16

Learning from This Book



LEARNING FROM LEVEL-1

We have summarised the learning in chapter seven. However, here is a brief recap.

First, accounts are maintained for a specific entity. Second, the accounting process culminates in two financial statements, the income statement and the balance sheet. The balance sheet, in case you forgot, shows what an entity *owns* (assets) and *owes* (liabilities) at a **point in time**. The income statement shows the profits earned by an entity in a **period of time**.

LEARNING FROM LEVEL-2

In Level-1 we prepared a balance sheet after each transaction. This is very useful for a beginner to understand the logic of accounting. However, real life accounting systems need to handle large volumes of transactions—hence the need for Level-2.

An accounting transaction is supported by a source document. The transaction is recorded in the Cash Book or Journal. These books provide a chronological record of financial transactions. Transactions from these two books are then posted in ledger accounts. Each ledger account contains transactions relating to a specific account head. At the end of each accounting period, or whenever financial statements are required, a trial balance is first prepared. This essentially contains the closing balances of ledger accounts. The trial balance is then used to prepare the financial statements.

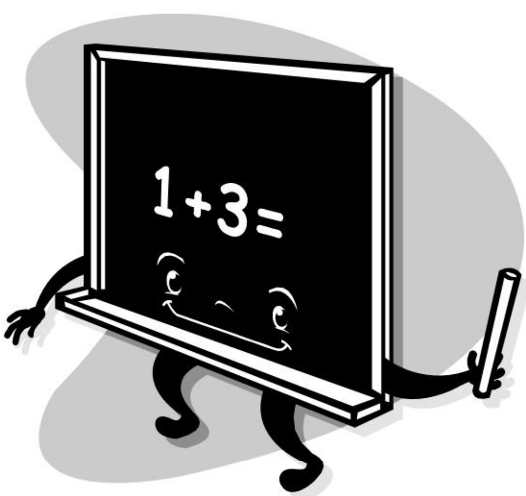
THE WAY FORWARD

If you look at the financial statements of a large organisation, you will find far more account-heads than what we have used. However, the account-heads we have covered reflect most high value items.

Now when you read an advanced text-book, you will find a detailed treatment of many of the concepts covered here. If you have read this book well, you will find that the core logic has been covered in this book. So, don't feel threatened by the bulk of such books.

Now from both of us and Ramaswamy, good-bye.

Glossary



Accounting	Recording of monetary transactions of an entity in a systematic manner
Accounting Entity	A specific entity [such as a company] for which accounts are maintained
Accrued Wages	Value of labour used but not paid for yet
Accumulated Depreciation	Cumulative value of depreciation
Asset	What an entity *owns* at a point in time
Bad Debt	Expense on account of irrecoverable debts
Balance Sheet	A financial statement showing what an entity *owns* and what it *owes* at a point in time
Bank loan	Loan due by an entity to a bank
Bank	Balances maintained by an entity with a bank
Capital	Amount *owed* to the owners by an entity
Cash	Cash on hand with an entity
Creditor	Amount *owed* by an entity to suppliers
Debtor	Amount due to an entity from customers buying on credit
Depreciation	A portion of the purchase cost of fixed assets treated as expense
Financial Statement	Accounting-based statement such as the balance sheet or the income statement
Fixed Asset	An asset such as building, equipment or furniture which the entity can use for more than a year
Income Statement	A financial statement showing the profits earned by an entity in a period of time
Investment	Amounts invested by an entity in shares, bonds and so on
Journal	A record of both debit and credit sides of non-cash transactions
Ledger	See T-Account
Liability	What an entity *owes* at a point time
Loss	Negative profits in a period of time
Profit	Excess of sales and other income over expenses, of an entity, in a period of time
Profit & Loss Account	An income statement prepared in a T-Account format

Retained Earnings	The cumulative profits earned by an entity and retained
Stocks	The value of inventory [raw material, work in progress, and finished goods] held by an entity at a point in time
T-Account	A T-shaped account with two sides, debit and credit. This represents a ledger account
Transaction	A monetary event in an entity that needs to be accounted for
Trial Balance	A statement containing T-Account balances, prepared to check the arithmetical accuracy of these balances

The McGraw·Hill Companies

THE GREEN COMPANY SOLUTION SHEET

ITEM	OPENING BALANCE SHEET	TRANSACTION 1	CLOSING BALANCE SHEET- After TRANSACTION 1	TRANSACTION 2	CLOSING BALANCE SHEET- After TRANSACTION 2	TRANSACTION 3	CLOSING BALANCE SHEET- After TRANSACTION 3	TRANSACTION 4	CLOSING BALANCE SHEET- After TRANSACTION 4	TRANSACTION 5	CLOSING BALANCE SHEET- After TRANSACTION 5
ASSETS [OWNED]											
TOTAL ASSETS											
LIABILITIES [OWED]											
TOTAL LIABILITIES											

THE YELLOW COMPANY SOLUTION SHEET

ITEM	OPENING BALANCE SHEET	TRANSACTION 1	CLOSING BALANCE SHEET- After TRANSACTION 1	TRANSACTION 2	CLOSING BALANCE SHEET- After TRANSACTION 2	TRANSACTION 3	CLOSING BALANCE SHEET- After TRANSACTION 3	TRANSACTION 4	CLOSING BALANCE SHEET- After TRANSACTION 4	TRANSACTION 5	CLOSING BALANCE SHEET- After TRANSACTION 5	TRANSACTION 6	CLOSING BALANCE SHEET- After TRANSACTION 6	TRANSACTION 7	CLOSING BALANCE SHEET- After TRANSACTION 7
ASSETS [OWNED]															
TOTAL ASSETS															
LIABILITIES [OWED]															
TOTAL LIABILITIES															

The McGraw-Hill Companies

THE BLUE COMPANY SOLUTION SHEET

ITEM	OPENING BALANCE SHEET	TRANSACTION 1	CLOSING BALANCE SHEET- After TRANSACTION 1	TRANSACTION 2	CLOSING BALANCE SHEET- After TRANSACTION 2	TRANSACTION 3	CLOSING BALANCE SHEET- After TRANSACTION 3	TRANSACTION 4	CLOSING BALANCE SHEET- After TRANSACTION 4	TRANSACTION 5	CLOSING BALANCE SHEET- After TRANSACTION 5	TRANSACTION 6	CLOSING BALANCE SHEET- After TRANSACTION 6	TRANSACTION 7	CLOSING BALANCE SHEET- After TRANSACTION 7
ASSETS [OWNED]															
TOTAL ASSETS															
LIABILITIES [OWED]															
TOTAL LIABILITIES															

The McGraw-Hill Companies

THE BROWN COMPANY SOLUTION SHEET

ITEM	OPENING BALANCE SHEET	TRANSACTION 1	CLOSING BALANCE SHEET- After TRANSACTION 1	TRANSACTION 2	CLOSING BALANCE SHEET- After TRANSACTION 2	TRANSACTION 3	CLOSING BALANCE SHEET- After TRANSACTION 3	TRANSACTION 4	CLOSING BALANCE SHEET- After TRANSACTION 4
ASSETS [OWNED]									
TOTAL ASSETS									
LIABILITIES [OWED]									
TOTAL LIABILITIES									

The McGraw-Hill Companies

THE RED COMPANY SOLUTION SHEET

ITEM	OPENING BALANCE SHEET	TRANSACTION 1	CLOSING BALANCE SHEET- After TRANSACTION 1	TRANSACTION 2	CLOSING BALANCE SHEET- After TRANSACTION 2	TRANSACTION 3	CLOSING BALANCE SHEET- After TRANSACTION 3
ASSETS [OWNED]							
TOTAL ASSETS							
LIABILITIES [OWED]							
TOTAL LIABILITIES							

The McGraw-Hill Companies

THE ORANGE COMPANY SOLUTION SHEET

ITEM	OPENING BALANCE SHEET	TRANSACTION 1	CLOSING BALANCE SHEET- After TRANSACTION 1	TRANSACTION 2	CLOSING BALANCE SHEET- After TRANSACTION 2	TRANSACTION 3	CLOSING BALANCE SHEET- After TRANSACTION 3
ASSETS [OWNED]							
TOTAL ASSETS							
LIABILITIES [OWED]							
TOTAL LIABILITIES							