

B.Com. IT Part- I
(NEP 2020 Introduced from 2022)
Subject: Financial Accounting
Unit -2 Preparation of Financial Statement

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Income Meaning

Income” signifies “what comes in”. Income is not confined to receipts from business only and means periodical receipts from one’s work, lands, investment etc. Income is that which comes in to a person as payment for labour or services rendered or as gain from lands, the investment of capital in a business etc.

Accounting Concept of Income

Income in its natural and commonly accepted sense means the balance of revenues and gains over expenses and losses. The term “income” means, as applied to a business, the profits made in that business.

1. According to Eric L. Kohler,

Income is “money or money equivalent earned or accrued during an accounting period, increasing the total of previously existing net assets, and arising from sales and rentals, of any types of goods or services, commissions, interest, gifts, recoveries from damage and windfalls from outside source.”

2. American Accounting Association defines business income as

“the increase in net assets measured determined by the excess of revenues over expenses.”

Classification of Income

(i) Capital Income.

The term ‘Capital Income’ means an income which does not grow out of or pertain to the running of the business proper. Capital profit is transferred to the Capital Reserve and is shown

in the Balance Sheet on the liabilities side while revenue profit is credited the Profit & Loss Account.

It is synonymous to the term 'Capital Gain'. For example, if a building costing Rs 10,000 purchased by a business for its use is sold for Rs 15,000, Rs 5,000 will be taken as a capital profit.

ii) Revenue Income.

Revenue Income means an income which arises out of and in the course of the regular business transactions of a concern.

For example, in the course of running business, the profit is made on sale, of goods, income is received from letting out the business property, dividends are received on business investments etc. All such incomes are revenue incomes. It should be noted that the terms "Revenue profit" and Revenue Income' synonymous.

Classification of Receipts

What are Receipts?

A receipt is a written acknowledgement of the transfer of something valuable from one party to another. In addition to the receipts that are normally given to customers by vendors and service providers, receipts are also given in business-to-business entities as well as stock market transactions.

However, receipts are classified into two types.

- a) Revenue receipts
- b) Capital receipts

Revenue Receipts

Revenue receipts are those receipts that do not lead to a claim on the government. They are hence termed non-redeemable. They are classified into tax and non-tax revenues. Tax revenues, a vital component of revenue receipts, have been bifurcated into direct taxes (personal income tax) and enterprises (corporation tax), indirect taxes like customs duties (taxes imposed on commodities imported into and exported out of India), excise taxes (duties levied on commodities manufactured within the nation), and service taxes.

Other direct taxes such as gift tax, wealth tax, and estate duty (now eradicated) have never brought a large amount of revenue, hence they are known as paper taxes.

Capital Receipts

The government also gets money in terms of loans or from the sale of its assets. Loans must be given back to the agencies from which they have borrowed. Hence, they establish liability. The sale of government assets, such as the sale of shares in Public Sector Undertakings (PSUs) that is known as Public Sector Undertakings disinvestment, minimizes the total amount of financial assets of the government.

Expenditure

Expenditure is a payment of cash or credit for goods or services, often by a business, organization or corporation. The purchase may be to obtain new assets, improve upon or repair existing ones, or reduce liability.

Classification of Expenditure:

i. Capital expenditure

A company incurs a capital expenditure when it buys an asset that has a life of more than one year (non-current asset). A building, for example, is a capital expenditure. It could also be a significant expansion or even the acquisition of a new asset that will, over time, generate substantial revenue for the organization. These investments usually require a substantial upfront investment and continuous maintenance to keep the asset functional, so many companies choose to finance these projects.

ii. Revenue expenditure

This type of expenditure refers to when a company spends money on a short-term benefit (less than one year). Revenue expenditures are often used to fund an organization's ongoing operations, which are known as its operating expenses. The company's income isn't impacted until the expenditure is recorded.

Accounting Concept of Income Measurement

The measurement of accounting income is the subject to several accounting concepts and conventions. Impact of accounting concepts and convention on measurement of the accounting income is given below –

1. Conservatism

Where an income of one period may be shifted to another period for the measurement of income is called as ‘conservatism approach.’ According to the convention of conservatism, the policy of playing safe is followed while determining a business income and an accountant seeks to ensure that the reported profit is not over stated. Measurement of a stock at cost or market price, whichever is less is one of the important examples as applied to measurement of income. But it must be insured that providing excessive depreciation or excessive provisions for a doubtful debt or excessive reserve should not be there.

2. Consistency

According to this concept, the principle of consistency should be followed in accounting practice. For example, in the treatment of assets, liabilities, revenues, and expenses to insure the comparison of accounting results of one period with another period.

Therefore, the accounting profession and the corporate laws of most of the countries require that financial statement must be made out on the basis that the figures stated are consistent with those of the preceding year.

3. Entity Concept

Proprietor and business are the two separate and different entities according to the entity concept. For example, an interest on capital is business expenditure, but for a proprietor, it is an income. Thus, we cannot treat a business income as personal income or vice-versa.

4. Going Concern Concept

According to this concept, it is assumed that business will continue for a long time. Thus, charging depreciation on a Fixed Asset is based on this concept.

5. Accrual Concept

According to this concept, an income must be recognized in the period in which it was realized and costs must be matched with the revenue of that period.

6. Accounting Period

It is desirable to adopt a calendar year or natural business year to know the results of business.

Measurement of Business Income

There are following two factors which are helpful in the estimation of an income –

- **Revenues** – Sale of goods and rendering of services are the way to generate revenue. Therefore, it can be defined as consideration, recovered by the business for rendering services and goods to its customers.
- **Expenses** – An expense is an expired cost. We can say the cost that have been consumed in a process of producing revenue are the expired cost. Expenses tell us - how assets are decreased as a result of the services performed by a business.

Measurement of Revenue

Measurement of the revenue is based on an accrual concept. Accounting period, in which revenue earned, is the period of revenue accrues. Therefore, a receipt of cash and revenue earned are the two different things. We can say that revenue is earned only when it is actually realized and not necessarily, when it is received.

Measurement of Expenses

- In case of delivery of goods to its customers is a direct identification with the revenue.
- Rent and office salaries are an indirect association with the revenue.

There are four types of events (given below) that need proper consideration about as an expense of a given period and expenditure and cash payment made in connection with those items –

- Expenditure, which are expenses of the current year.
- Some expenditure, which are made prior to this period and has become expense of the current year.
- Expenditure, which is made this year, becomes expense in the next accounting periods. For example, purchase of fixed assets and depreciation in next up-coming years.
- Expense of this year, which will be paid in next accounting years. For example, outstanding expenses.

Measurement of Costs

Measurement of costs can be determined by –

- **Historical Costs** – To determine periodic net income and financial status, historical cost is important. Historical cost actually means - outflow of cash or cash equivalents for goods and services acquired.
- **Replacement Costs** – Replacing any asset at the current market price is called as replacement cost.

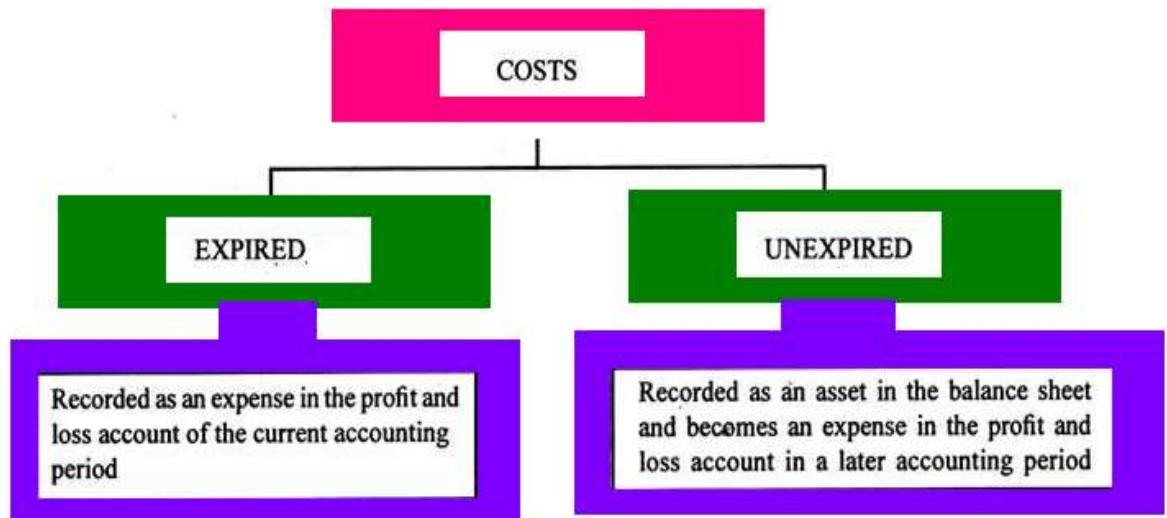
Basis of Measurement of Income

Following are the two significant basis of measurement of income –

- **Accrual Basis** – In an accrual basis accounting, incomes are recognized in a company's books at the time when revenue is actually earned (however, not essentially received) and expenses is recorded when liabilities are incurred (however, not essentially paid for). Further, expenses are compared with revenues on the income statement when the expenses expire or title has been transferred to the buyer, and not at the time when the expenses are paid.
- **Cash Basis** – In a cash basis accounting, revenues and expenses are recognized at the time of physical cash is actually received or paid out.

Expired Cost

When we pay the cost of anything, we either receive product or service. Some product's benefit will be day or two day. But some products benefits will be 10 to 20 years. So, all the cost of product or services whose total benefit will have obtained, will be expired cost. We will show it as our business expense.



For example

We have taken the service of electricity and pay the bill of electricity of \$ 1000. It is our expired cost. We will show electricity expense in our account as \$ 1000. But if we still did not receive the electricity service benefit but paid the electricity bill. Its cost will not say as expired cost because we have to take benefit. So, we will show prepaid electricity expense in our accounts. For example, we will receive next month same service. So, at the end of the next month, our same cost will be expired.

Instructions

1. In case of showing expired cost of inventory, we will have to count inventory physically. All the expired inventory quantity will be shown for dead inventory.
2. Now, from historical record, we check the price of same inventory. We will multiply the quantity with its price. It will be expired cost of inventory.
3. We will record it by

Loss of expired inventory account Debit

Inventory or purchase account Credit

Manufacturing Account:

Manufacturing of goods is the conversion of raw materials into finished or semi-finished goods. There are many products which need to be manufactured before selling to the general public like lays, Parle G biscuits, coca cola etc. In order to manufacture finished goods, companies will

acquire raw materials, engage labour, and other inputs necessary to change the raw materials into finished goods.

The main purpose of preparing the manufacturing account is to ascertain the cost of goods manufactured during the financial year and to ascertain the amount of any profit or loss occurred during the manufacturing process.

The manufacturing account provides information of all the expenses and costs incurred in the preparation of the goods to be sold. It includes the expenses incurred in preparing the goods but not the finished goods. All the expenses including the cost of raw materials, the cost of machines and their maintenance, the salaries and wages of both skilled and unskilled workers, depreciation of the assets are also included under this account.

Majorly Manufacturing Costs are Divided into the Following Types:

1. **Direct Material Costs:** These are costs which are directly used in the manufacturing of a product. For example, materials used in the preparation of plastic tables like glue plastic sheets, paints etc.
2. **Direct labour costs:** Costs which are paid directly to the worker involved in the manufacturing of a product. For example, in the preparation of Plastic tables wages are paid to the worker involved directly.
3. **Direct Expenses:** Expenses incurred in the manufacture of a product. For example, charges for special equipment used in the process of manufacture.
4. **Factory Overheads:** Expenses incurred indirectly in the manufacturing of a product. For example, factory rents, factory power and lighting etc.
5. **Administrative Expenses:** Administrative expenses are the expenses incurred in the process of planning, controlling and directing the business organization. For example, office rents, office electricity etc.
6. **Selling and Distribution Expenses:** Expenses incurred in the process of selling, marketing and distributing the goods manufactured. For example cost of advertising, carriage outwards, salary to salesperson etc.
7. **Finance Costs:** Expenses such as bank charges, discounts allowed and other monetary expenses are included in Factory Expenses.

Steps Involved in the Preparation of the Manufacturing Account

The following steps will be followed in order to prepare a manufacturing account:

1. Opening stock of raw materials will be added to the purchases and the stock of raw materials shall be deducted. We will get the cost of materials used during the period.
2. All the Indirect costs will be added
3. All the indirect manufacturing costs will be added
4. To get the production cost of all goods completed, opening stock of Work in progress shall be added and thereafter closing stock of work in progress will be deducted
5. The total in the manufacturing account shows the total available for sale during the period.

The total cost of production = Prime cost + Factory overhead

The Prime cost = Direct material + Direct labour + Direct expenses

Direct material cost = Opening stock of raw materials + purchase of raw materials + carriage inwards – returns outwards – closing stock of raw materials.

Factory overhead expenses = All expenses related to the factory (indirect expenses)

The format

Manufacturing Account
for the year ended

Opening stock of raw materials	xxxx	
Add purchase of raw materials	xxxxxx	
Add carriage inwards (if any)	<u>Xxxx</u>	
	Xxxxxx	
Less Returns outwards (of raw materials)	<u>xxxx</u>	
	Xxxxxx	
Less Goods drawings (if any)	<u>xxxx</u>	
	xxxxxx	
Less Closing stock of raw materials	<u>xxxx</u>	
Cost of Direct Materials		xxxxxxxx
Add Direct labour		xxxxxxxx

Add Direct expenses (Eg: royalties)		<u>xxxxxxx</u>
Prime Cost		xxxxxxx
<u>Add Factory overhead expenses</u>		
Factory lighting	xxxxxxx	
Factory heating	xxxxxxx	
Factory insurance	xxxxxxx	
Factory rent	xxxxxxx	
Factory maintenance	xxxxxxx	
Factory indirect wages	xxxxxxx	
Factory supervisor's wages	xxxxxxx	
Depreciation on plant & machinery	xxxxxxx	
Depreciation on factory building	xxxxxxx	
Depreciation on factory furniture	xxxxxxx	
Depreciation on factory motor van	xxxxxxx	
Depreciation on other factory fixed assets	<u>xxxxxxx</u>	<u>xxxxxxx</u>
		<u>xxxxxxx</u>
Add Opening stock of work in progress		xxxxxxx
		<u>xxxxxxx</u>
Less Closing stock of work in progress		xxxxxxx
Cost of production		xxxxxxx

Format of Trading Account of a manufacturing concern

Sales of finished goods		xxxxxx
Less Returns inwards		<u>xxxxxx</u>
		xxxxxxx
<u>Less Production cost of goods sold</u>		
Opening stock of finished goods	xxxxxx	
Add Cost of production	<u>xxxxxxx</u>	(-)

	XXXXXX	
Less closing stock of finished goods	<u>XXXXX</u>	
	XXXXXXXX	
Less finished goods drawings by the owner	XXXXX	XXXXXXXX
Gross profit or Gross loss		<u>XXXXXX</u>

Trading Account:

Trading account is used to determine the gross profit or gross loss of a business which results from trading activities. Trading activities are mostly related to the buying and selling activities involved in a business. Trading account is useful for businesses that are dealing in the trading business. This account helps them to easily determine the overall gross profit or gross loss of the business. The amount thus determined is an indicator of the efficiency of the business in buying and selling.

The formulae for calculating gross profit is as follows:

Gross profit = Net sales – Cost of goods sold

Net sales = Gross sales of the business minus sales returns, discounts and allowances.

Items of Trading Account: The following items usually appear in the debit and credit sides of the trading account.

Debit Side Items:

The value of opening stocks of goods (i.e., the stock of goods with which the business was started). Net purchase made during the year (i.e., purchases less returns). Direct expenses, if any.

Credit Side Items:

Total sales made during the period less the value of returns, i.e., net sales. The value of closing stock of goods.

The Trading Account: Items

- Sales
- Purchases
- Returns Inwards (Sales Returns)
- Returns Outwards (Purchase Returns)
- Carriage Inwards
- Opening Stock

- Closing Stock

Trading Account
(For the year ended...)

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Opening stock	Xxx	By Sales	xxx
To Purchases	xxx	Less: Return Inwards	<u>(xxx)</u>
Less: Return Outwards	<u>(xxx)</u>	By Closing stock	Xxx
To Wages	Xxx	By Gross Loss	Xxx
To Carriage Inwards	Xxx		
To Freight Inwards/cartage	Xxx		
To Gross Profit c/d	Xxx		
	xxx		xxx

Profit and Loss Account

Profit and loss account shows the net profit and net loss of the business for the accounting period. This account is prepared in order to determine the net profit or net loss that occurs during an accounting period for a business concern. Profit and loss account gets initiated by entering the gross loss on the debit side or gross profit on the credit side. This value is obtained from the balance which is carried down from the Trading account.

A business will incur many other expenses in addition to the direct expenses. These expenses are deducted from the profit or are added to gross loss and the resulting value thus obtained will be net profit or net loss.

Net Profit

- **The Profit and Loss Account shows the net profit (or loss) for the reporting period.**
- **The net profit equals the gross profit minus all expenses and overheads.**

Profit & Loss Account			
(For the year ended...)			
Dr.			Cr.
Particulars	Amount	Particulars	Amount
To Gross loss b/d	Xxx	By Gross Profit b/d	Xxx
To Salaries	Xxx	By Discount Received	Xxx
To Office rent, rates and taxes	Xxx	By Commission Received	Xxx
To Printing & stationery	Xxx	By Bank Interest	Xxx
To Telephone expenses	Xxx	By Rent received	Xxx
To Postage & telegram	Xxx	By Dividend on shares	Xxx
To Discount Allowed	Xxx	By Interest earned on debentures	Xxx
To Insurance	Xxx	By Profit on sale of asset	Xxx
To Audit Fees	Xxx	By Net loss	Xxx
To Electricity charges	Xxx		
To Repairs & renewals	Xxx		
To Depreciation	Xxx		
To Advertisement	Xxx		
To Carriage Outwards	Xxx		
To Bad Debts	Xxx		
To Provision for Bad debts	Xxx		
To Selling commission	Xxx		
To Bank Charges	Xxx		
To Interest on loans	Xxx		
To Loss on sale of asset	Xxx		
To Net Profit	Xxx		
	xxx		xxx

Balance Sheet

A balance sheet is a financial statement that contains details of a company's assets or liabilities at a specific point in time. It is one of the three core financial statements (income statement and cash flow statement being the other two) used for evaluating the performance of a business.

A balance sheet serves as reference documents for investors and other stakeholders to get an idea of the financial health of an organization. It enables them to compare current assets and liabilities to determine the business's liquidity, or calculate the rate at which the company generates returns. Comparing two or more balance sheets from different points in time can also show how a business has grown.

Key elements & components of a balance sheet

A balance sheet consists of two main headings: assets and liabilities. Let us take a detailed look at these components.

Assets

An asset is something that the company owns and that is beneficial for the growth of the business. Assets can be classified based on convertibility, physical existence, and usage.

a. **Convertibility:** This describes whether the asset can be easily converted to cash. Based on convertibility, assets are further classified into current assets and fixed assets.

1. **Current assets:** Assets which can be easily converted into cash or cash equivalents within a duration of one year. Examples include short-term deposits, marketable securities, and stock.
2. **Fixed assets:** Assets which cannot be easily or readily converted to cash. For example, buildings, machinery, equipment, or trademarks.

b. **Physical existence:** Assets can be of two types, tangible and intangible.

1. **Tangible assets:** Assets which you can see and feel, like office supplies, machinery, equipment, and buildings.
2. **Intangible assets:** Assets which do not have physical existence, like patents, brands, and copyrights.

c. **Usage:** Assets can be classified as operating and non-operating assets.

1. **Operating assets:** Assets which are necessary to conduct business operations. For example, buildings, machinery, and equipment.
2. **Non-operating assets:** Short-term investments or marketable securities that are not necessary for daily operations.

Liabilities

Liabilities are what the company owes to other parties. This includes debts and other financial obligations that arise as an outcome of business transactions. Companies settle their liabilities by paying them back in cash or providing an equivalent service to the other party. Liabilities are listed on the right side of the balance sheet.

Depending on context, liabilities can be classified as current and non-current.

1. **Current liabilities:** These include debts or obligations that have to be fulfilled within a year. Current liabilities are also called short-term assets, and they include accounts payable, interest payable, and short-term loans.

2. **Non-current liabilities:** These are debts or obligations for which the due date is more than a year. Non-current liabilities, also called long-term liabilities, include bonds payable, long-term notes payable, and deferred tax liabilities.

Balance Sheet of As at.....

Liabilities	Rs.	Assets	Rs.
Capital:		Fixed Assets:	
Opening Balance xxxx		Good will	
Add: Net Profit xxxx		Land	
(Less: Net Loss)		Building	
Less: Drawings xxxx		Plant & Machinery	
Long-term Liabilities:		Furniture & Fixtures	
Loan		Investment:	
Current liabilities:		Current Assets:	
Income received-in-advance		Closing stock	
Sundry Creditors		Accrued income	
Outstanding Expenses		Prepaid expenses	
Bills Payable		Sundry Debtors	
Bank Overdraft		Bills Receivable	
		Cash at Bank	
		Cash in Hand	

Adjustment Entries

A crucial step of the accounting cycle is making adjusting entries at the end of each accounting period.

An adjusting entry is an entry made to assign the right amount of revenue and expenses to each accounting period. It updates previously recorded journal entries so that the financial statements at the end of the year are accurate and up-to-date.

When you make adjusting entries, you're recording business transactions accurately in time.

This is extremely helpful in keeping track of your receivables and payables, as well as identifying the exact profit and loss of the business at the end of the fiscal year.

Types of Adjusting Entries

The amount of adjusting entries a business makes depends on their number of financial transactions. However, we divide adjusting entries into three main types: accruals, deferrals, and non-cash expenses.

- Adjusting entries update previously recorded journal entries to match expenses and revenues with the accounting period that they occur. These entries are only made when using the accrual basis of accounting.
- There are three main types of adjusting entries: accruals, deferrals, and non-cash expenses.
- Accruals include accrued revenues and expenses.
- Deferrals can be prepaid expenses or deferred revenue.
- Non-cash expenses adjust tangible or intangible fixed assets through depreciation, depletion, etc.

Accruals

You record accrued revenues by:

- Debiting the accounts receivable account and,
- Crediting the service revenue account.

They are recorded as an adjusting entry by:

- Debiting the expense account
- And crediting accounts payable.

Deferrals

The adjusting entry for prepaid expenses includes:

- A debit to the expense account (insurance expense, for example)
- A credit to prepaid expense account previously recorded.

This change is done by recording the following adjusting entry:

Debiting the unearned revenue account

Crediting the service revenue account

Non-Cash Expenses

The most common method used to adjust non-cash expenses in business is depreciation.

The adjusting entry to record the depreciation expense includes:

- A debit to the depreciation expense account
- A credit to the accumulated depreciation account

Rectification of Errors

Need of Rectification

1. For the preparation of correct Accounting Records.
2. Preparation of P & LA/c with corrected figures to ascertain correct Profit or Loss.
3. To find out the true financial position of the firm by preparing Balance Sheet with corrected figures.

Types of Errors from Rectification Point of View

Case I : Errors which don't affect the Trial Balance or Two Sided Errors

Errors don't Affecting Trial Balance

- (1) Errors of complete commission.
- (2) Wrong recording in the books of original entry.
- (3) Complete commission from posting.
- (4) Errors of posting to the wrong A/c but on the correct side.
- (5) Compensating errors.
- (6) Errors of principle.

Case II: Errors which affect the Trial Balance or One Sided Errors.

Errors Affecting Trial Balance

1. Error in totalling of subsidiary books as undercast or over cast.
2. Error in the balancing of ledger accounts.
3. Error in posting to the correct Account but wrong amount.
4. Error of partial omission.

Meaning of Accounting Errors:

Accounting errors are the mistakes committed in bookkeeping and accounting. The mistake may be one relating to routine or one relating to principle. They may occur in entering the

transactions in the journal or subsidiary books or they may creep at the time of posting into the ledger.

Thus, errors may be committed while recording, classifying or summarizing the accounting transactions. The error may be the result of an act of omission or commission.

Classification of Errors

1. Errors of Omission:

When a transaction is not recorded by mistake in the books of accounts, it is called an error of omission. The omission may be partial or complete.

Partial Omission may happen in relation to any subsidiary book. Here the transaction is entered in the subsidiary book but not posted to the ledger.

For example, goods returned by a customer has been entered in the sales returns book but not posted to the credit of customer's account. Similarly, cash paid to the supplier has been entered in the payment side of the Cash Book but not posted to the debit of supplier's account.

Complete omission can happen when the transaction is completely omitted from the books of accounts. For example, a bookkeeper failed to enter an invoice from the sales daybook.

2. Error of Commission:

When a transaction is entered in the books of accounts, it might be entered wrongly. It may be entered partially or incorrectly. Such error is called an error of commission. These errors arise often due to the ignorance or negligence or absent-mindedness of the accountant. It may be of different types. Examples of such errors are as follows:

(a) Errors relating to subsidiary books:

These are three types:

(i) Entering wrong amount in a subsidiary book, e.g., a purchase of Rs.430 may be entered in the Purchase Day Book as Rs.340 due to wrong transposition of figures.

(ii) Entering the transaction in a wrong subsidiary book, e.g., a purchase transaction may be entered in sales daybook and a sales transaction may be entered in the purchase daybook.

(iii) Wrong casting or carry forward of a subsidiary book. Casting refers to the process of totaling the daybooks periodically. A mistake in relation to totaling is called 'error in casting'.

If there is excess totaling, the error is 'over casting' and short totaling is 'under casting'. Sometimes, error may be the result of wrong carry forward of the total from one page of the

daybook to another, e.g., the total of a page may be Rs.235 and carried forward to the next page as Rs.325.

(b) Errors relating to ledger:

These errors may be subdivided broadly into two types. They are: errors of posting and errors in balancing.

Error of posting may be further being subdivided as follows:

- (i) Posting wrong amount on the right side of an account. Example. Sale of Rs.560 to Mr.Raja is entered as Rs.650 in the debit side of his account from the Sales Day Book.
- (ii) Posting the same amount twice to an account. Example. A cash receipt of Rs.1000 from Mr.Ram is credited twice to his account.
- (iii) Posting the correct amount to the wrong side of the right account. Example. A purchase of goods from Mr. Raj for Rs.1000 is debited to his account [instead of crediting],
- (iv) Posting wrong amount to the wrong side of right account. Example. A purchase of Rs.1000 from Mr.Sam is debited to his account as Rs. 10,000.
- (v) Posting the correct amount to the wrong account but on the right side. Example. A sale of goods to S.Anish for Rs.1000 is wrongly debited to G.Anish a/c.
- (vi) Posting correct amount to the wrong account and on the wrong side. Example. A sale of Rs.1000 to S.Anish is wrongly credited to G.Anish a/c.

Errors in balancing:

Errors may arise in balancing the account resulting in excess or short balance of the account.

3. Errors of Principle:

These errors occur when entries are made against the principles of accounting. Example. Purchase of computer for office use is wrongly entered in the Purchases Day Book. Capital expenditure should not be treated as revenue expenditure.

These errors may be committed:

- (a) Due to the inability to make a distinction between revenue and capital items;
- b) Due to inability to make a difference between business expenses and personal expenses;
- (c) Due to inability to make a difference between productive expenses and non-productive expenses, e.g., wages paid for production may be debited to salaries a/c or salaries paid to office employees may be debited to wages a/c.

4. Compensating Errors:

These are the errors, which compensate themselves in the net results, i.e., over debit of one account is neutralized by an over credit in some other account to the same extent. Similarly a wrong credit might have been compensated by some wrong debit in some other account.

For example, if tax paid Rs.2, 500 is debited in Tax a/c as Rs.3, 000 and interest received Rs.3, 500 is credited in the interest a/c as Rs.4, 000, the excess debit of Rs.500 in tax a/c is compensated by an excess credit of Rs.500 in interest a/c.

This type of error may be committed in combination of different errors in different accounts. Normally the presence of this type of errors will not be revealed by the trial balance.

Location of Errors

Steps to locate Error in Trial Balance

1. Check the totals of both the columns of trial balance.
2. Check that the cash balance and bank balance, [discount](#) allowed (if any) and discount received (if any) have been written in the trial balance correctly.
3. Calculate the exact difference in the trial balance. Check whether there is an omission of any ledger balance in the trial balance.
4. Also, check the [ledger](#) accounts and balances again. Check the posting of ledger balances to trial balances.
5. Then, check the totaling of subsidiary books. Check, if there is any difference in carrying forward and brought forward of totals. Thorough checking of subsidiary books and totals should be done. Posting to ledger accounts should also be checked thoroughly. Subsidiary books should be checked again in case the difference is 1/-, 100, 112 etc
6. If the difference is very big, the balance of various [accounts](#) should be checked. This can also be checked by comparing the current trial balance with the previous year trial balance. In case the difference is so material it should be checked.
7. It should be checked that the correct amount has been posted on the correct side. It is possible that the amount has been posted on the wrong side.
8. If still there is a difference in trial balance, complete checking of the books should be done. Posting of all the entries (opening, closing) should be checked. It is always better to start from the nominal accounts.

Even after applying all the procedure and measures, if we are unable to detect all the errors then we shall transfer the difference to a suspense account temporarily.

Suspense Account

When the trial balance does not tally due to the one-sided errors in the books, an accountant puts the difference between the debit and credit side of the trial balance on the shorter side as the Suspense A/c. As and when we locate and rectify the errors, the balance in the Suspense A/c reduces and consequently becomes zero. Thus, we cannot categorize the Suspense A/c. It is a temporary account and can have debit or credit balance depending upon the situation.

While using the Suspense A/c to rectify the one-sided errors, the accountant needs to follow the following steps:

1. Identification of the account with the error.
2. Ascertainment of the excess debit or credit or short debit or credit in the above account.
3. In case of short debit or excess credit in an **account**, we need to debit the concerned account. Whereas, in case of short credit or excess debit in an account we need to credit the concerned account.
4. Pass the necessary journal entry by debiting or crediting the Suspense A/c

Effect on Profit

Effect of error depends on the nature of effected accounts. If errors relate to nominal account, it will either increase or reduce the profit and rectification will reduce excess profit or Loss. Effect of error on Trading and Profit account ultimately effect the Balance-Sheet of a company too, because reduced profit or excess profit ultimately transferred to capital account, which is a part of the Balance Sheet.

There are some errors, which effect Trading or Profit and Loss account and Balance sheet simultaneously, like entry of depreciation will affect profit as well as value of the Fixed Assets.

Some entry may effect on Balance sheet only like, for instance omission of entry of cash paid to purchase fixed assets will affect Balance Sheet of a firm only.