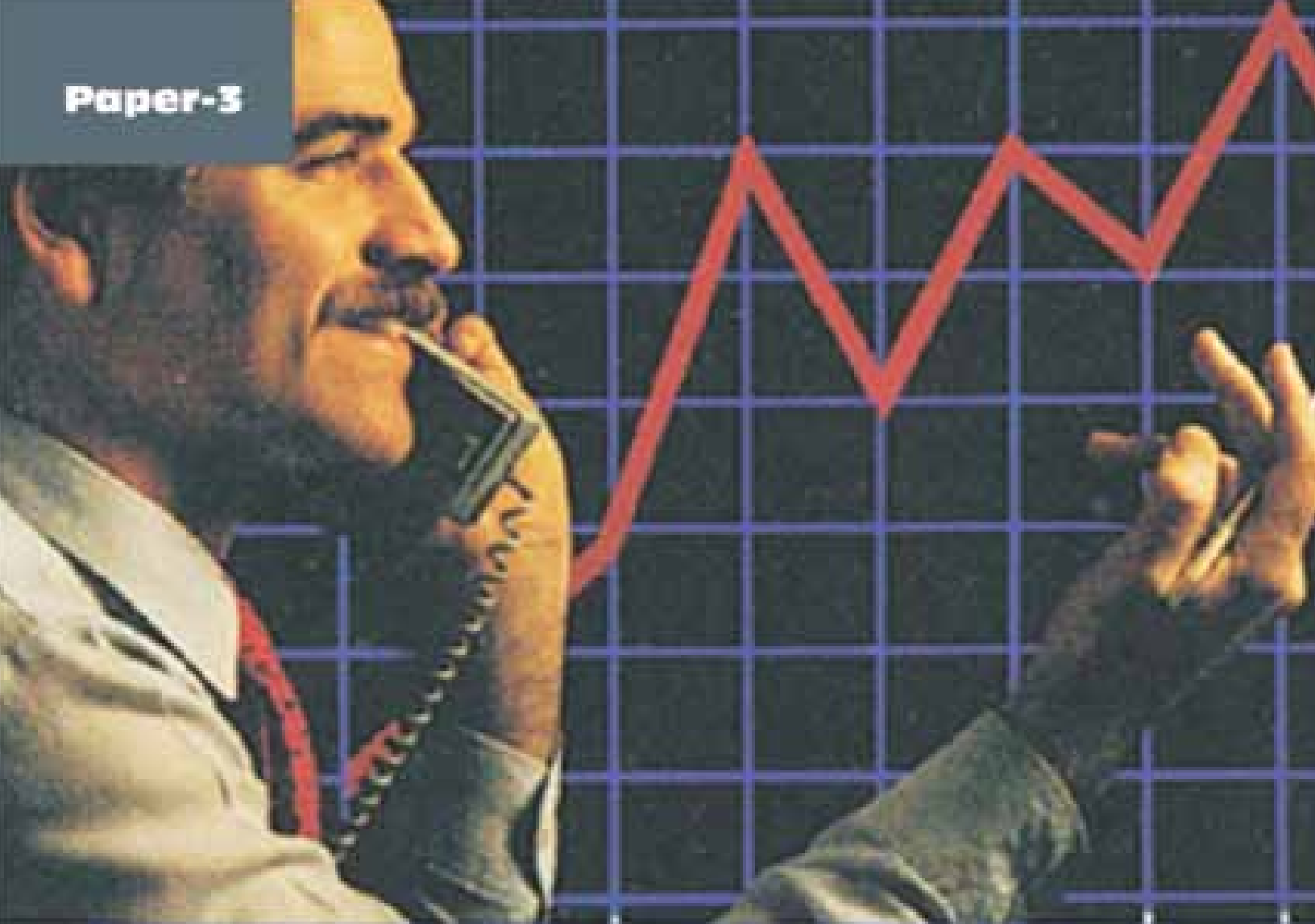


Paper-3



Foundation Programme

Financial Accounting



**THE INSTITUTE OF
Company Secretaries of India**

IN PURSUIT OF PROFESSIONAL EXCELLENCE
Statutory body under an Act of Parliament

FOUNDATION PROGRAMME
FINANCIAL ACCOUNTING

C O N T E N T S

STUDY I

INTRODUCTION TO ACCOUNTING

Meaning of Accounting

Branches of Accounting

Functions of Accounting

Users of Accounting Information

Characteristics of Accounting Information

Systems of Accounting

Advantages of Accounting

Limitations of Accounting

Role of Accountant

Book Keeping

Book Keeping and Accounting

Accounting Principles, Concepts and Conventions

Accounting Policies

Accounting – A Measurement Discipline

Double Entry System

Accounts

Classification of Accounts

Rules of Debit and Credit

Significance of Debit and Credit

Accounting Equation

[SELF-TEST QUESTIONS](#)

STUDY II

RECORDING OF TRANSACTIONS

Accounting Cycle

Journal

Ledger

Ledger Posting

Balancing Ledger Accounts

Subsidiary Books of Accounts

Purchases Book

Sales Book

Purchases Returns Book

Sales Returns Book

Bills Receivable Book

Bills Payable Book

Cash Book

Petty Cash Book

Imprest System of Petty Cash

General Journal

Trial Balance

[SELF-TEST QUESTIONS](#)

STUDY III

BANK RECONCILIATION STATEMENT

Introduction

Deposits and Withdrawals

Bank Pass Book

Bank Reconciliation Statement

Causes of Difference Between Bank Balance Shown by
Cash Book and Pass Book

Significance of Bank Reconciliation Statement

Preparation of Bank Reconciliation Statement

[SELF-TEST QUESTIONS](#)

STUDY IV

RECTIFICATION OF ERRORS

Introduction

Classification of Errors

Errors which Affect the Agreement of Trial Balance

Errors not Disclosed by Trial Balance

Steps to Locate Errors

Rectification of Errors

Rectification before the Preparation of Trial Balance

Suspense Account

Rectification after the Preparation of Trial Balance
but before the Preparation of Final Accounts

Rectification in the Next Accounting Period

Ascertainment of Correct Profit

[SELF-TEST QUESTIONS](#)

STUDY V

FINAL ACCOUNTS OF NON - CORPORATE ENTITIES

Capital and Revenue Items

Capital and Revenue Expenditures

Deferred Revenue Expenditure

Comparison between Capital Expenditure and Deferred Revenue Expenditure

Capital Receipts and Revenue Receipts

Capital Profits and Revenue Profits

Capital Losses and Revenue Losses

Final Accounts

Main Principles of Preparing Trading and Profit and Loss Account

Trading Account

Profit and Loss Account

Difference between Trading Account and Profit and Loss Account

Balance Sheet

Difference between Trial Balance and Balance Sheet

Difference between Profit and Loss Account and Balance Sheet

Classification of Assets

Classification of Liabilities

Marshalling of Balance Sheet

Matching Principle

Adjustment Entries

Closing Entries

Limitations of Financial Statements

Manufacturing Account

[SELF-TEST QUESTIONS](#)

STUDY VI

ACCOUNTING FOR DEPRECIATION

Meaning of Depreciation

Accounting Concept of Depreciation

Characteristics of Depreciation

Causes of Depreciation

Objectives of providing Depreciation

Factors in Measurement of Depreciation

Accounting Treatment

Methods of Providing Depreciation

Change in Method of Depreciation

Profit or Loss Sale of Fixed Assets

Loss by Accident and Insurance Claim

Depreciation and Replacement of Assets

[SELF-TEST QUESTIONS](#)

STUDY VII

ACCOUNTING FOR BILLS OF EXCHANGE

Introduction

Bills of Exchange

Features of Bills of Exchange

Advantages of Bills of Exchange

Promissory Note

Distinction between Bills of Exchange and Promissory Note

Bills Receivable and Bills Payable

Bills Receivable and Bills Payable Books

Posting of Bills Books

Endorsement of Bills

Discounting of Bills

Bills for Collection

Grace Days

Accounting Entries

Dishonour of Bills

Noting and Protesting Charges

Renewal of Bills

Insolvency of Drawee

Retiring a Bill under Rebate

Accommodation Bills

Distinction between Trade Bill and Accommodation Bill

[SELF-TEST QUESTIONS](#)

STUDY VIII

ACCOUNTS OF NON-PROFIT ORGANISATIONS

Introduction

Receipts and Payments Account

Income and Expenditure Account

Distinction between Receipts and Payments Account and Income and Expenditure Account

Profit and Loss Account and Income and Expenditure Account

Balance Sheet

Preparation of Income and Expenditure Account on the Basis of Receipts and Payments Account

Preparation of Income and Expenditure Account when Trial Balance is given

Accounting Treatment of Specified Items

Preparation of Receipts and Payments Account when Ledger Balances and other Information are given

Preparation of Receipts and Payments Account when Income and Expenditure Account, Balance Sheet and other Information are given

Preparation of Balance Sheet when Receipts and Payment Account and Income and Expenditure Account are given

Receipts and Expenditure Account

[SELF-TEST QUESTIONS](#)

STUDY IX

SINGLE ENTRY ACCOUNTS

Meaning of Single Entry System

Salient Features of Single Entry System

Difference between Double Entry System and Single Entry System

Advantages of Single Entry System

Limitations of Single Entry System

Statement of Affairs

Distinction between Statement of Affairs and Balance Sheet

Ascertainment of Profit by Statement of Affairs Method

Ascertainment of Profit by Conversion Method

Preparation of Final Accounts under Single Entry System

[SELF-TEST QUESTIONS](#)

STUDY X

ACCOUNTING FOR CONSIGNMENTS AND JOINT VENTURES

I. ACCOUNTING FOR CONSIGNMENTS

Meaning of Consignment

Features of consignment

Distinction between Sales and Consignment

Pro-forma Invoice

Account Sales

Consignee's Commission

Accounting Treatment in the Books of Consignor

Accounting Treatment in the Books of Consignee

Valuation of Stock

Loss of Goods on Consignment

Methods of Preparing Consignment Account

Advance by Consignee

Return of Damaged Goods by Consignee

Fall in Market Value of Goods

II. ACCOUNTING FOR JOINT VENTURES

Meaning of Joint Venture

Features of Joint Venture

Difference between Joint Venture and Consignment

Accounting Treatment for Joint Ventures –

— When No Separate Set of Books is maintained

— When Separate Set of Books is maintained

[SELF-TEST QUESTIONS](#)

STUDY XI

PARTNERSHIP ACCOUNTS

Meaning of Partnership

Partnership Deed

Difference between Partnership and Joint Venture

Capital Accounts - Fixed and Fluctuating

Profit and Loss Appropriation Account

Interest on Capital

Interest on Drawings

Salary to Partners

Adjustment of Profit

Guarantee of Profit to a Partner

Admission of New Partner

Treatment of Reserves on Admission of Partner

Revaluation of Assets and Liabilities on Admission of a Partner

Change in Profit Sharing Ratio

Sacrificing Ratio

Treatment of Goodwill

Methods of Valuation of Goodwill

Accounting Treatment of Goodwill on Admission of a Partner

Goodwill to be inferred

Adjustment of Goodwill on Change in Profit Sharing Ratio

Contribution and Purchase of Share by a Partner

Adjustment regarding Capital of Partners

Retirement of a Partner

Treatment of Reserves and Undistributed Profit on Retirement

Revaluation of Assets and Liabilities on Retirement of a Partner

Calculation of New Profit Sharing Ratio

Treatment of Goodwill on Retirement

Ratio of Gains

Capitals in Profit Sharing Ratio

Computation of Retiring Partner's Interest in the Firm

Payment of Retiring Partner's Interest

Purchase of Retiring Partner's Share by Remaining Partners

Death of a Partner

Joint Life Policy

Repayment of the Amount due to the Deceased Partner

Dissolution of Partnership

Settlements of Accounts of Partners

Accounting Treatment on Dissolution of Partnership

Distinction between Revaluation Account and Realisation Account

Return of Premium on Dissolution

Insolvency of a Partner

Decision in *Garner v. Murray*

Insolvency of all Partners

[SELF-TEST QUESTIONS](#)

STUDY XII

INSURANCE CLAIMS

Introduction

Claims under Fire Insurance Policies

Some Important Terms in Connection with the Fire Insurance Policies

Claims for Loss of Stock

Poor Selling Line and Treatment of Abnormal Items

Accounting Entries in the Books of the Insured

Claim for Loss of Fixed Assets

Claim for Loss of Profits or Consequential Loss

Determination of Amount of Claim for Loss of Profits

Determination of the Amount to be Insured under Loss of Profits Policy

Claims under other Types of Insurances

[SELF-TEST QUESTIONS](#)

TEST PAPERS

[Test Paper 1/2009](#)

[Test Paper 2/2009](#)

QUESTION PAPERS OF PREVIOUS SESSIONS

[June 2010](#)

[December 2010](#)

INTRODUCTION TO ACCOUNTING

1. MEANING OF ACCOUNTING

Accounting is used by business entities for keeping records of their money or financial transactions. A businessman who invested money in his business would like to know whether his business is making profit or incurring loss, the position of his assets and liabilities and whether his capital in the business has increased or decreased during a particular period.

The definition given by the American Institute of Certified Public Accountants clearly brings out the meaning of accounting. According to it accounting is “the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part atleast, of a financial character and interpreting the results thereof”. The definition brings out the following as attributes of accounting:

- (i) *Accounting is an art* : Accounting is classified as an art, as it helps us in attaining our aim of ascertaining the financial results, that is, operating profit and financial position. Analysis and interpretation of financial data require special knowledge, experience and judgement.
- (ii) *It involves recording, classifying and summarizing* : Recording means systematically writing down the transactions and events in account books soon after their occurrence. Classifying is the process of grouping transactions or entries of the same type at one place. This is done by opening accounts in a book called ledger. Summarising involves the preparation of reports and statements from the classified data (ledger) understandable and useful to management and other interested parties. This involves preparation of final accounts namely profit and loss account and balance sheet.
- (iii) *It records transaction in terms of money* : This provides a common measure of recording and increases the understanding of the state of affairs of the business.
- (iv) *It records only those transactions and events which are of financial character*. If a transaction has no financial character then it will not be measured in terms of money and not recorded.
- (v) It is the art of interpreting the results of operations to determine the financial position of the enterprise, the progress it has made and how well it is getting along.

Thus accounting has the following stages:

- (i) The transactions of a business that have , at least in part, a financial character are identified and recorded.
- (ii) The recording is done in a manner which identifies the different classes and types of transactions.
- (iii) The resulting records are summarized in such a way that the owners or other interested parties in the business can see the overall effects of all the transactions. The statements prepared by the summarizing process is known as financial statements which will show the profit or loss made by the business over a period of time and the total capital employed in the business.
- (iv) Such financial statements are used by management and others to make business decisions.

2. BRANCHES OF ACCOUNTING

Accounting has three main forms or branches viz. financial accounting, cost accounting and management accounting.

- (i) *Financial Accounting* : It is concerned with record-keeping directed towards the preparation of trial balance, profit and loss account and balance sheet.
- (ii) *Cost Accounting* : Cost accounting is the process of accounting for costs. It is a systematic procedure for determining the unit cost of output produced or services

rendered. The main functions of cost accounting are to ascertain the cost of a product and to help the management in the control of cost.

- (iii) *Management Accounting* : Management accounting is primarily concerned with the supply of information which is useful to management in the decision making for the efficient running of the business and thus in maximising profits.

3. FUNCTIONS OF ACCOUNTING

The following are the main functions of accounting:

- (i) *Keeping Systematic Records* : Accounting is done to keep a systematic record of financial transactions.
- (ii) *Protecting and Controlling Business Properties* : Accounting helps to see that there is no unauthorised use or disposal of any assets or property belonging to the firm, because proper records are maintained. Accounting will furnish information about money due from various persons and money due to various parties. The firm can see that all amounts due to it are recovered in due time and that no amount is paid unnecessarily.
- (iii) *Ascertaining the Operational Profit/Loss* : Accounting helps to determine the results of the activities in a given period, usually a year, i.e. to show how much profit has been earned or how much loss has been incurred. This is done by keeping a proper record of revenues and expenses of a particular period and then matching the revenues with the corresponding costs.
- (iv) *Ascertaining the Financial Position of the Business* : Balance sheet is prepared to ascertain the financial position of the firm at the end of a particular period. It shows the value of the assets and the liabilities of a business entity.
- (v) *Facilitating Rational Decision Making* : Accounting has taken upon itself the task of collection, analysis and reporting of information at the required point of time to the required levels of authority in order to facilitate rational decision making.
- (vi) *Accounting as Information System* : Accounting, being the language of business, is used to communicate financial and other information to individuals, organisation, governments etc. about various aspects of business and non-business entities. For example, when a firm applies for a loan from a bank, it will have to submit details of its business activities in terms of operating results (profit or loss) and the financial position (assets and liabilities). Similarly the shareholders or prospective investors must have financial information in order to evaluate the performance of the management. Many laws require that extensive financial information be reported to various government departments such as income-tax, sales tax, company law board and so on. Accounting is a discipline that collects, reports and interprets financial information about the activities of different organisations. Hence actual accounting is concerned with communicating the results of an organisation.

4. USERS OF ACCOUNTING INFORMATION

Accounting is of primary importance to the proprietors and the managers. However, other persons such as creditors, prospective employees, etc. are also interested in the accounting information.

1. *Owners/Shareholders* : The primary aim of accounting is to provide necessary information to the owners related to their business.
2. *Managers* : In large business organisations and in corporations, there is separation of ownership and management functions. The management of such business are more concerned with the accounting information because they are answerable to the owners.
3. *Prospective Investors* : The person who is contemplating an investment in a business will like to know about its profitability and financial position. They derive these informations from the accounting reports of the concern.

4. *Creditors, Bankers and other Lending Institutions* : Trade creditors, bankers and other lending institutions would like to be satisfied that they will be paid on time. The financial statements help them in judging such position. Banks and other lending agencies rely heavily upon accounting statements for determining the acceptability of a loan application.
5. *Government* : The Government is interested in the financial statements of business enterprise on account of taxation, labour and corporate laws.
6. *Employees* : Employees are interested in financial statements on accounts because their wage increase and payment of bonus depend on the size of the profit earned.
7. *Regulatory Agencies* : Various Government departments and agencies such as Company Law Board, Registrar of Companies, Tax Authorities etc. use accounting reports not only as a basis for tax assessment but also in evaluating how well various business are operating under regulatory legislation.
8. *Researchers* : Accounting data are also used by the research scholars in their research in accounting theory as well as business affairs and practices.
9. *Customers* : Customers may also have either short-term or long-term interest in the reporting entity or long-term interest in the reporting entity and they may be satisfied with the profitability, liquidity and solvency position.

5. CHARACTERISTICS OF ACCOUNTING INFORMATION

The various characteristics of accounting information are as follows:

- (i) *Relevance* : The information shall be relevant in order to influence the economic decisions of users by helping them to evaluate the events at all times. Accounting information have a bearing on decision by helping investors, creditors and other users to evaluate past, and future events or it confirms or corrects prior expectations. The relevance of information is affected by its nature and materiality.
- (ii) *Reliability* : Reliability relates to the confidence in the accounting information in the sense that the information must faithfully represent what it intends to present; it must be factual. Information should be free from material errors and bias. The key aspects of reliability are faithful representation, substance over form, neutrality, prudence and completeness.
- (iii) *Comparability* : Accounting information of an enterprise is useful when it is comparable with similar information for the same enterprise in other periods of time and similar information with other enterprises at the same time. Thus, the information should be presented in a consistent manner over time and consistent between entities to evolve users to make significant comparisons.
- (iv) *Understandability* : Information should be readily understandable by users who are expected to have a reasonable knowledge of business, economics and accounting and a willingness to study the information with reasonable diligence.
- (v) *Timeliness* : The more quickly the information is communicated or provided to the users, the more it is likely to influence their decisions. Hence, accounting information should be made available at appropriate time without delays for prompt decision-making.
- (vi) *Cost-benefit* : The accounting information must be useful to most of the people who want to use it and preparing that useful information must not be costly and time consuming process. The emphasis is on cost-benefit considerations and the benefits derived from information should normally exceed the cost of providing it.
- (vii) *Verifiability* : Verifiability ensures the truthfulness of the recorded transactions, which can be checked by persons other than the accountant himself.

- (viii) *Neutrality* : Accounting information is neutral in the sense that it should be free from bias and it should not favour one group over another. Neutrality is significant especially for the external users of accounting information.
- (ix) *Completeness* : Completeness in the sense that all material information that is necessary to investors, creditors or other users for assessing the financial position and operating results of the organization have been disclosed in the financial statements.

6. SYSTEMS OF ACCOUNTING

Basically there are two systems of accounting:

- (i) *Cash System of Accounting* : It is a system in which accounting entries are made only when cash is received or paid. No entry is made when a payment or receipt is merely due. In other words, it is a system of accounting in which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual payments or actual receipts are made in cash. It may not treat any revenue to have been earned or even sales to have taken place unless cash is actually paid by customers. It has no relevance whether the receipts pertain to previous period or future period. Similarly, expenses are restricted to the actual payments in cash during the current year and it is immaterial whether the payments have been made for previous period or future period.

Cash basis of accounting is incompatible with the matching principle of income determination. Hence the financial statements prepared under this system do not present a true and fair view of operating results and financial position of the organization. Cash system of accounting is suitable in the following cases:

- (i) Where the organizations are very small or in the case of individuals, where it is difficult to allocate small amounts between accounting periods; and
 - (ii) Where credit transactions are almost negligible and collections are uncertain e.g. accounting in case of professionals i.e. doctors, lawyers, firms of chartered accountants/company secretaries. But while recording expenses they take into account the outstanding expenses also. In such a case, the financial statement prepared by them for determination of their income is termed as Receipts and Expenditure Account.
- (ii) *Accrual System of Accounting* : This is also known as mercantile system of accounting. It is a system in which transactions are recorded on the basis of amounts having become due for payment or receipt. Accrual basis of accounting, attempts to record the financial effects of the transactions, events, and circumstances of an enterprise in the period in which they occur rather than recording them in period(s) in which cash is received or paid by the enterprise. It recognises that the buying, selling and other economic events that affect enterprises' performance often do not coincide with the cash receipts and payments of the period. The purpose of accrual basis accounting is to relate the revenue earned in terms of cost incurred so that reported net income measures an enterprise's performance during a period instead of merely listing its cash receipts and payments. Accrual basis of accounting recognises assets, liabilities or components of revenues and expenses for amounts received or paid in cash in past and amounts expected to be received or paid in cash in the future. The following are the essential features of accrual basis:
 - (i) Revenue is recognised as it is earned irrespective of whether cash is received or not;
 - (ii) Costs are matched against revenues on the basis of relevant time period to determine periodic income, and
 - (iii) Costs which are not charged to income are carried forward and are kept under continuous review. Any cost that appears to have lost its utility or its power to generate future revenue is written off as a loss.

7. ADVANTAGES OF ACCOUNTING

The following are the advantages of accounting:

- (i) *Maintenance of business records* : All financial transactions are recorded in a systematic manner in the books of accounts so that there is no need to rely on memory. It is impossible to remember the business transactions which have grown in size and complexity.
- (ii) *Preparation of financial statements* : Proper recording of transactions facilitated the preparation of financial statements i.e. the trading and profit and loss account and balance sheet.
- (iii) *Comparison of results* : Accounting information when properly recorded can be used to compare the results of one year with those of earlier years so that the significant changes can be analysed.
- (iv) *Decision making* : Accounting information helps the management to plan its future activities for preparing budgets and coordination of various activities in different departments.
- (v) *Evidence in legal matters* : Properly recorded accounting information can be produced as evidence in a court law.
- (vi) *Provides information to interested parties* : Interested parties like owners, creditors, management, employees, customers, government, etc. are interested in accounting information.
- (vii) *Helps in taxation matters* : Income-tax and/Sales Tax authorities depend on the accounts maintained by the business.
- (viii) *Valuation of business* : When the business is to be sold, the accounting information can be utilized to determine the proper purchase price.

8. LIMITATIONS OF ACCOUNTING

The following are the limitations of accounting :

- (i) *Accounting information is expressed in terms of money* : The accountant measures only those events that are in financial nature i.e. capable of being expressed in money. Non-monetary items or events are not measured and recorded in accounting.
- (ii) *Accounting information based on estimates* : Sometimes accounting data is based on estimates and estimates may be inaccurate.
- (iii) *Accounting information may be biased* : Accounting information is not without personal influence or bias of the accountant. In measuring income accountant applies a choice between different methods inventory valuation, depreciation methods, treatment of capital and revenue items etc. Hence due lack of objectivity income arrived may not be true in certain cases.
- (iv) *Fixed Assets are recorded as the original cost* : This value may change over time and so there may be great difference between the original cost and current replacement cost. Balance sheet may not show true and fair view of the financial affairs on a particular date.
- (v) *Accounting can be manipulated* : Accounting information may not be used as the only test of managerial performance on the basis of more profits. Profits for a period can be manipulated omitting such costs as advertisement, depreciation and son on.
- (vi) *Money as a measurement unit changes in value* : Money value does not remain stable. Unless price level changes are considered in measurement of income, the accounting information will not show true financial results.

9. ROLE OF ACCOUNTANT

The role of accountant may be summarized as under :

- (i) *Maintenance of books of accounts* : The primary role of an accountant is to offer his

services for maintaining systematic records of financial transactions in order to ascertain the net profit or loss for the accounting period and the financial position as on a particular date.

- (ii) *Statutory audit* : Every limited company is required to appoint a chartered accountant as an auditor who is statutorily required to report each year whether the financial statements have been prepared in accordance with the generally accepted accounting principles, accounting standards and legal requirements and they show a true and fair view of the financial position and profit and loss.
- (iii) *Internal audit* : In addition to statutory audit big companies employ its own staff to conduct internal audit to ensure that the transactions are recorded, classified and summarized in accordance with the established accounting procedures and the instructions of the management are being followed throughout the company.
- (iv) *Budgeting* : Budgeting means the planning business activities before they occur. On completion of the actual activities for a given period, the planned activities are compared with the actual to find out the variation if any.
- (v) *Taxation* : An accountant can handle the taxation matters of a business or of a person and can represent before the tax authorities and settle the tax liability under the prevailing statute. He also assists in reducing the tax burden by proper tax planning.
- (vi) *Investigation* : Accountants are often called upon to carry out investigation to ascertain the financial position of the business for the information of interested parties.
- (vii) *Management Advisory Service* : An accountant is largely responsible for internal reporting to the management for planning, controlling, decision-making on matters for long-term plans. He provides management consultancy services in the areas of management information systems expenditure control, and evaluation of appraisal techniques.
- (viii) *Other activities* : Accountants among many other duties perform duties such as arbitrator for settling of disputes, share registration work, liquidators, cost accountants, etc.

10. BOOK-KEEPING

Book-keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner. It is concerned with the permanent record of all transactions in a systematic manner to show its financial effect on the business. It covers procedural aspects of accounting work and includes record keeping function. It is the science and art of correctly recording in books of account all those business transactions that result in the transfer of money or money's worth. It is mechanical and repetitive. This work is book-keeping is of clerical nature and usually entrusted to junior employees of accounts section of a business house. Now-a-days most of the book-keeping work is done through the use of mechanical and electronic devices. In fact accounting is based on a systematic and efficient book-keeping system. The main purpose behind maintaining book-keeping is to show correct position regarding each head of income and expenditure as well as assets and liabilities. Further book-keeping is meant to show the effect of all the transactions made during the accounting period upon the financial position of the business.

11. BOOK-KEEPING AND ACCOUNTING

Book-keeping and accounting are often used interchangeably but they are different from each other. Accounting is a broader and more analytical subject. It includes the design of accounting systems which the book-keepers use, preparation of financial statements, audits, cost studies, income-tax work and analysis and interpretation of accounting information for internal and external end-users as an aid to making business decisions. This work requires more skill, experience and imagination. The larger the firm, the greater is the responsibility of the

accountant. It can be said that accounting begins where book-keeping ends. Book-keeping provides the basis for accounting.

The following are the points of distinction between book-keeping and accounting :

<i>Book-keeping</i>	<i>Accounting</i>
(i) It is concerned with the recording of transactions.	It is concerned with the summarizing of the recorded transactions.
(ii) The work of book-keeping is mainly routine and clerical in nature and is increasingly being done by computers.	The work of accountant requires higher level of knowledge, conceptual understanding and analytical skill.
(iii) Book-keeping constitute the base for accounting.	Accounting is considered as the language of business.
(iv) Book-keeping is done in accordance with basic accounting concepts and conventions.	The methods and procedures for accounting for analysis and interpretations for financial reports may vary from firm to firm.
(v) Financial statements do not form part of book-keeping.	Financial statements are prepared in accounting process from the book-keeping records.
Financial position of the business cannot be ascertained through book-keeping records.	Financial position of the business is ascertained on the basis of accounting reports.

12. ACCOUNTING PRINCIPLES, CONCEPTS AND CONVENTIONS

Accounting is often called the language of business through which normally a business house communicates with the outside world. In order to make this language intelligible and commonly understood by all, it is necessary that it should be based on certain uniform scientifically laid down standards. These standards are termed as accounting principles.

Accounting principles have been defined as “the body of doctrines commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exist”. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experiences, historical precedents, statements by individuals and professional bodies and regulations of government agencies. In short, accounting principles are guidelines to establish standards for sound accounting practices and procedures in reporting the financial status and periodic performance of a business. These principles can be classified into two categories (i) Accounting concepts; and (ii) Accounting conventions.

Accounting Concepts

A concept is a belief about the desirability of a method or procedure. Accounting concepts are defined as basic assumptions on the basis of which financial statements of a business entity are prepared. It is used as a foundation for formulating various methods and procedures for recording and presenting the business transactions. The important accounting concepts are given below:

(i) *Business Entity Concept* : According to this concept, business is treated as a unit of entity separate from its owners, creditors, managers and others. It is treated to have a distinct accounting entity which controls the resources of the concern and is accountable therefor. Accounts are kept for a business entity as distinguished from the persons associated with it. All transactions of the business are recorded in the books of the business from the point of view of the business. Transactions are recorded between the owner and the firm, for instance, when capital is provided by the owner, the accounting record will show that the firm as having received so much money and as owing to the proprietor. This concept is based on the sense that proprietors entrust resources to the management and the management is expected to use these

resources to the best advantage of the firm and to account for the resources placed at its disposal. Hence, in accounting for every type of business organisation, be it sole tradership or partnership or joint stock company, is treated as a separate accounting entity.

The failure to recognise the business as a separate accounting entity would make it extremely difficult to evaluate the performance of the business alone since the private transactions would get mixed and introduce bias in the results. The business entity concept defines the range and boundaries of the accountant's activity and limits the number of transactions that are to be included in the records of the enterprise. The overall effect of adopting this concept is:

- (i) Only the business transactions are recorded and reported and not the personal transactions of the owners.
- (ii) Income or profit is the property of the business unless distributed to the owners.
- (iii) The personal assets of the owners or shareholders are not considered while recording and reporting the assets of the business entity.

(ii) *Money Measurement Concept* : A unit of exchange and measurement is necessary to account for the transactions of business enterprises in a uniform manner. The common denominator chosen in accounting is the monetary unit. Money is the common denominator in terms of which the exchange ability of goods and services, including labour, natural resources and capital are measured. Money measurement concept holds that accounting is a measurement and communication process of the activities of the firm that are measurable in monetary terms. Thus, only such transactions and events as can be interpreted in terms of money are recorded. Events which cannot be expressed in money terms do not find place in the books of account though they may be very important for the business. Non-monetary events like, death, dispute, sentiments, efficiency etc. are not recorded in the books, even though these may have great effect. Accounting therefore, does not give a complete account of the happenings in a business or an accurate picture of the conditions of the business. Thus, accounting information is perceived as essentially monetary and quantified.

Any unit of measurement over a period of time has its own drawbacks. Though a universally acceptable measure of value, it suffers from territorial limitations. It gets affected seriously by economic differences between various territories as well as political and social differences. Again, within a territory its value changes over a period of time. In some cases this change is rapid as well as violent. The system of accounting treats all units of money as the same irrespective of their time dimension. This has created doubts about the utility of the accounting data, leading to the introduction of inflation accounting.

(iii) *Cost Concept* : According to cost concept, the various assets acquired by a concern or firm should be recorded on the basis of the actual amounts involved or spent. This amount or cost will be the basis for all subsequent accounting for the assets. The cost concept does not mean that the assets will always be shown at cost. The fixed asset will be recorded at cost at the time of its purchase but it may systematically be reduced in its value by charging depreciation. These assets ultimately disappear from the balance sheet when their economic life is over and they have been fully depreciated and sold as scrap. It may be noted that if nothing has been paid for acquiring something, it would not be shown in the accounting books as an asset.

The cost concept has the advantage of objectivity since the amount concerned is agreed upon by the two parties concerned and does not depend upon the subjective views of any individual. It is much more objective than the alternative of trying to estimate current values. Users may arrive at their own estimate of current or market value by analysing reported accounting and non-accounting information. Hence, it is not much relevant for investors and other users because they are more interested in knowing what the business is actually worth today rather than the original cost.

(iv) *Going Concern Concept* : Business transactions are recorded on the assumption that the business will continue for a long-time. There is neither the intention nor the necessity to

liquidate the particular business venture in the foreseeable future. Therefore, it would be able to meet its contractual obligations and use its resources according to the plans and pre-determined goals. It is on this concept that a clear distinction is made between assets and expenses. Transactions are recorded in such a manner that the benefits likely to accrue in future from money spent now or the future consequences of the events occurring now are also taken into consideration. It is because of this concept that fixed assets are valued on the basis of cost less proper depreciation keeping in mind their expected useful life ignoring fluctuations in the prices of these assets.

However, if it is certain that a business will continue for a limited period, then the accounting records will be kept on the basis of expected life of the business and there will be no need for such detailed accounting information as to revenue and capital expenditure.

When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going concern is not impaired. But the enterprise will not be considered as a going concern if it goes into liquidation or it has become insolvent. If the assumption of the going concern is not valid, the financial statements should clearly state this fact.

(v) *Dual Aspect Concept* : This concept is based on double entry book-keeping which means that accounting system is set up in such a way that a record is made of the two aspects of each transaction that affects the records. The recognition of the two aspects to every transaction is known as dual aspect concept. Modern financial accounting is based on such recognition and record of the two aspects of every transaction. One entry consists of debit to one or more accounts and another entry consists of credit to some other one or more accounts. However, the total amount debited is always equal to the total amount credited. The claims against the assets of a business are by creditors and the owners. Therefore, at any point of time total assets of a business are equal to its total liabilities. Liabilities to outsiders are known as liabilities, but liabilities to owners is referred to as capital. Thus, this concept expresses the relationship that exists among assets, liabilities and the capital in the form of an accounting equation which is as follows:

$$\begin{aligned}\text{Assets} &= \text{Liabilities} + \text{Capital, or} \\ \text{Capital} &= \text{Assets} - \text{Liabilities}\end{aligned}$$

Since accounting system requires recording of the two aspects of each transaction, this concept shows the effect of each transaction on them. Assets and liabilities are two independent variables and capital is the dependent variable, for it is the difference between assets and liabilities. Any change in any one of these three, must lead to a change in any of the other two. An increase in assets without a corresponding increase in liabilities or a corresponding decrease in another assets, must represent an increase in capital. Conversely, an increase in liability without a corresponding decrease in another liability will indicate a decrease in capital.

(vi) *Realisation Concept* : There is a saying that there is many a slip between the cup and the lip. Accounting recognises this in the sense that no profit is supposed to accrue only on the acquisition of anything, however certain it may be that it will be sold at a profit. Hence, according to this concept revenue is recognised only when a sale is made. Unless money has been realised i.e., either cash has been received or a legal obligation to pay has been assumed by the customer, no sale can be said to have taken place and no profit can be said to have arisen. It prevents business firms from inflating their profits by recording incomes that are likely to accrue i.e. expected incomes or gains are not recorded.

(vii) *Accrual Concept* : Every transactions and events affects, one or more or all the three aspects viz., assets, liabilities and capital. Normally all transactions are settled in cash but even if cash settlement has not taken place, it is proper to bring the transaction or the event concerned into the books. This concept implies that the income should be measured as a difference between revenues and expenses rather than the difference between cash received and disbursements. This necessitates certain adjustments in the preparation of income statement. In relation to revenue the account should exclude amounts relating to subsequent period but provide for

revenue recognised though not received in cash. Likewise, in relation to costs, provide for costs incurred but not paid and exclude costs paid for subsequent period.

It is not necessary that there is an immediate settlement in cash for any transaction or event. If a transaction or event has occurred, its effects will follow and it is better to recognize the effect immediately rather than to wait for actual cash settlement. The flow of transactions cannot conform exactly to the prescribed accounting period. Therefore, accrued revenues and costs are recognised as they are earned and incurred and recorded in the financial statements of the period. On the basis of this concept adjustment entries relating to outstanding and prepaid expenses and income received in advance etc. are made. They have their impact on both the profit and loss account and the balance sheet.

(viii) *Accounting Period Concept* : It is customary that the life of the business is divided into appropriate parts or segments for analysing the results shown by the business. Each part or segment so divided is known as an accounting period. It is an interval of time at the end of which the income or revenue statement and balance sheet are prepared in order to show the results of operations and changes in the resources which have occurred since the previous statements have been prepared. Normally the accounting period consists of twelve months.

(ix) *Revenue Match Concept* : This concept is based on accounting period concept. In order to determine the profit earned or loss suffered by the business in a particular defined accounting period, it is necessary that expenses of the period should be matched with the revenues of that period. The term 'matching' means appropriate association of related revenues and expenses. Therefore, income made by the business during a period can be ascertained only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. According to this concept adjustments should be made for all outstanding expenses, accrued incomes, unexpired expenses and unearned incomes etc. while preparing the final accounts at the end of the accounting period.

Accounting Conventions

The term 'convention' denotes customs or traditions or practice based on general agreement between the accounting bodies which guide the accountant while preparing the financial statements. It is a guide to the selection or application of a procedure. In fact financial statements, namely, the profit and loss account and balance sheet are prepared according to the following accounting conventions:

(i) *Consistency* : The consistency convention implies that the accounting practices should remain the same from one year to another. The results of different years will be comparable only when accounting rules are continuously adhered to from year to year. For example, the principle of valuing stock at cost or market price whichever is lower should be followed year after year to get comparable results. Similarly, if depreciation is charged on fixed assets according to the diminishing balance method, it should be done year after year. The rationale behind this principle is that frequent changes in accounting treatment would make the financial statements unreliable to the persons who use it.

The consistency convention does not mean that a particular method of accounting once adopted can never be changed. There is scope for desirable changes as a result of changes in the circumstances in which accounting operates. When an accounting change is desirable, it should be fully disclosed in the financial statements along with its effect in terms of rupee amounts on the reported income and financial position of the year in which the change is made.

(ii) *Disclosure* : Apart from statutory requirement good accounting practice also demands all significant information should be fully and fairly disclosed in the financial statements. All information which is of material interest to proprietors, creditors and investors should be disclosed in accounting statements. This convention is gaining more importance because most of big business units are in the form of joint stock companies where ownership is divorced from management. The Companies Act makes ample provisions for disclosure of essential information that there is no chance of any material information being left out.

(iii) *Conservatism* : Financial statements are usually drawn up on a conservative basis. There are two principles which stem directly from conservatism.

- (a) The accountant should not anticipate income and should provide all possible losses, and
- (b) Faced with the choice between two methods of valuing an asset the accountant should choose a method which leads to the lesser value.

Examples:

- Making provisions for bad debts in respect of doubtful debts.
- Amortising intangible assets like, goodwill, patents, trade marks, etc. as early as possible.
- Valuing the stock in hand at lower of cost or market value.

(iv) *Materiality* : According to the convention of materiality accountants should report only what is material and ignore insignificant details while preparing the final accounts. This is because otherwise accounting will unnecessarily be overburdened with minute details. It is not possible to lay down any fixed standard by which materiality can be judged. The decision is to be made by the accountant or the auditor on the basis of professional experience and judgement where there is no unanimous opinion on the subject.

Moreover, an item may be material for one purpose while immaterial for another. It is generally felt that in respect of items appearing in the profit and loss account and having an effect on the profit for the year, materiality should be judged in relation to the profits shown by the profit and loss account as also the expenditure under the concerned head. As regards items appearing on the balance sheet, it is generally felt that, if they have no effect upon the profit for the year, materiality may be judged in relation to the groups to which the assets or liabilities belong e.g. for any item of current liabilities in relation to total current liabilities.

The following are the points of distinction between accounting concepts and conventions:

- (i) A concept is a theoretical idea forming a set of practices while a convention is a method or procedure accepted by general agreement.
- (ii) Accounting concepts are not based on accounting conventions whereas accounting conventions are based on accounting concepts.
- (iii) Accounting concepts are not internally inconsistent while accounting conventions are internally inconsistent.
- (iv) Personal judgement has no role in the adoption of accounting concepts. But for accounting conventions, personal judgement may play a crucial role.
- (v) Accounting concepts are established by law while accounting conventions are established by common accounting practices.
- (vi) There is uniform application of accounting concepts in different organizations while it may not be so in a case of accounting conventions.

13. ACCOUNTING POLICIES

Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions. The broad framework for determination of acceptable alternatives for measurement and reporting of business transactions is provided by the generally accepted accounting principles. The accounting standards issued by professional accounting bodies limit and reduce alternatives out of which accounting policies are to be selected by an enterprise for measurement and reporting of business transactions. Thus, the specific accounting policies are selected by an enterprise in conformity with generally accepted accounting principles and the accounting standards. Therefore, it must be borne in mind that it is not possible to have an exhaustive list of accounting policies which are applicable across different enterprises and countries. Divergence in accounting policies followed by different enterprises for preparation and presentation of financial

statements is the result of stage of development of economy, financial markets, legal system, tax rules, accounting profession and so on. Users of accounting information come across financial statements prepared and presented by different enterprises by following divergent accounting policies in conformity with General Accepted Accounting Principles (GAPP) and accounting standards. For example, as per matching concept, depreciation should be treated as cost of doing business and matched with revenue of the same period. But for calculation of amount of depreciation Accounting Standard-6 permits application of straight line method, written down value method etc. Another very significant factor in determination of profits is valuation of inventory for which alternative methods can be adopted. Besides these, treatments of goodwill, valuation of investment, valuation of fixed assets etc. are the significant areas which require standardization of accounting policies to ensure relevance and reliability of accounting information.

In view of the flexibility provided in measurement and presentation of the significant aspects of business, the usefulness of financial statements of different enterprises is severally eroded.

14. ACCOUNTING - A MEASUREMENT DISCIPLINE

The term measurement in general used to indicate height, weight, distance, grades and so on. However, in accounting, measurement means the assignment of numerical values to the transactions of business. Accounting information in respect of profit or loss, assets and liabilities is expressed in the monetary unit of the country that is rupees in India, dollars in U.S.A. and so on. The use of money is helpful in measuring the total value of the assets as well as the individual value of each asset of an economic entity. Such a measurement is not possible under barter system. The profit and loss account and the balance sheet contain the quantitative information in terms of money for those who make decisions between alternative choices available to them. This aspect has made accounting as a measurement discipline. Thus accounting is a measurement discipline as it deals with the monetary measurement of inputs and as a result it provides a basis for measuring the efficiency or performance of enterprise.

Measurement means assignment of numerical values to specific attributes or characteristics of selected objects or events. It means that asset, liability or change in capital must have a relevant attribute that can be expressed in monetary units with sufficient reliability. However, value refers to the benefits to be derived from objects, abilities or ideas. Valuation is essentially an economist's concept. Value is the utility of an economic resource to the person enjoying its use. In accounting, monetary unit is used for the value of an object, abilities or ideas. In other words, value is measured in terms of money. If the value of the machine is taken as Rs.2,00,000, it is only one type of value popularly called acquisition cost or historical cost. So value is indicated by numerical values in terms of money. The value is always measured in terms of money by the accountant. The measurement is a broader concept than valuation. Thus the concept of measurement includes valuation.

Generally four measurement bases are usually accepted in accounting parlance i.e. (i) Historical Cost; (ii) Current Cost; (iii) Reliasable Value; and (iv) Present Value.

- (i) *Historical Cost* : It means acquisition price, i.e., the amount of cash paid to acquire an asset such as land, building, furniture, etc. Liabilities are recorded at the amount of proceeds received in exchange for the obligation.
- (ii) *Current Cost* : Assets are carried at the amounts of cash or cash equivalent that would have to be paid if the same or equivalent assets were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
- (iii) *Realisable Value* : As per this valuation basis, assets are recorded at the amount of cash or cash equivalent that would be realized by selling the assets in a routine manner. Similarly, liabilities are recorded at their settlement values.

- (iv) *Present Value* : As per present value concept, an asset is shown in the balance sheet at the sum of present discounted net cash inflows that the asset is expected to generate in the normal course of business activities. Similarly, liabilities are disclosed at the present discounted value of future net cash outflows that are expected to be required to satisfy the liability in normal or due course of business activities.

15. DOUBLE ENTRY SYSTEM

There are two systems of keeping records i.e. (i) single entry system and (ii) double entry system. The single entry system appears to be time saving and economical but it is unscientific as under this system some transactions are not recorded at all whereas some other transactions are recorded only partially. On the other hand, the double entry system is based on scientific principles and is, therefore, used by most of the business houses. The system recognises the fact that every transaction has two aspects and records both aspects of each and every transaction. Under this system in every transaction an account is debited and some other account is credited. The crux of accountancy lies in finding out which of the two accounts are affected by a particular transaction and out of these two accounts which account is to be debited and which account is to be credited.

Merits of Double Entry System

- (i) It keeps a complete record of business transactions. Both personal accounts and impersonal accounts are kept. The entire information regarding the value of assets and profits earned during the year can be easily obtained.
- (ii) It provides a check on the arithmetical accuracy of both the accounts, since every debit has corresponding credit to it and vice-versa.
- (iii) The detailed profit and loss account can be prepared to show profits earned or loss suffered during any given period.
- (iv) The system makes possible the comparison of purchases as well as sales, expenditure, income etc. of a current year with those of the previous years, thus enabling a businessman to control his business activities. The balance sheet can be prepared at any specified point of time or any date showing the actual amount of assets, liabilities and capital.
- (vi) The system being a scientific one, it prevents commission of fraud and if a fraud is committed it can be easily detected.
- (vii) The accurate details with regard to any account can be easily obtained.

16. ACCOUNTS

In order to obtain the details of an item, the business transactions are recorded in accounts. Thus the transaction, recorded in the document is analysed in order to show the effect of the transaction and transferred to a separate head is known as 'account'. An account is an individual record of a person, firm, or thing, an item of income or an expense. According to Kohler's Dictionary for Accountants, an account has been defined as a formal record of a particular type of transaction expressed in money.

Thus an account is prepared for each type of asset, liability, owner(s) equity, revenue and expense. For example, the account of cash would show the cash receipts, cash payments and balance of cash in hand, an account of a person would show the business transactions that have taken place with that person and net position in respect of money owed by or to him. A specimen of an account is given in Study Lesson No. II - under the topic 'Ledger'.

17. CLASSIFICATION OF ACCOUNTS

Accounts are broadly classified into two classes: (i) Personal Accounts and (ii) Impersonal Accounts. The latter are further sub-divided into (a) Real Accounts and (b) Nominal Accounts. Thus all accounts can be classified into Personal, Real and Nominal Accounts.

(i) **Personal accounts** : These accounts show the transactions with customers, suppliers, money lenders, the banks and the owner. Personal accounts can take the following forms:

- (a) *Natural personal accounts* : The term natural persons means persons who are the creation of God. For example proprietor's account, supplier's account, receiver's account (Mohan's A/c, Rajesh's A/c, etc.).
- (b) *Artificial personal accounts* : These accounts include accounts of corporate bodies or institutions which are recognised as persons in business dealings. For example, any limited company's account, bank account, insurance company's account, any firm's account, any club's account, etc.
- (c) *Representative personal accounts* : These are accounts which represent a certain person or group of persons. In books, the names of the parties will appear. Since these accounts are in many number and of the same nature, the accounts standing against these accounts, are added and put under one common title. For example, if the business is not able to pay rent, say, for 15 shops, then all landlords of these shops stand as creditors and the amount due to them is added and put under one common head known as "Rent Outstanding Account". This account is a personal account representing so many landlords. Salary outstanding, rent prepaid, interest outstanding, interest received in advance, etc. are some of the other examples.

(ii) **Real accounts** : Real accounts may be of the following types:

- (a) *Tangible real accounts* : These are accounts of such things as are tangible i.e. which can be seen, touched or felt physically. Examples– land, building, furniture, cash etc. (please note that bank account is a personal account and is not a real account because bank account is the account of some banking company which is an artificial person).
- (b) *Intangible real accounts* : These accounts represent such things which cannot be touched. Of course, they can be measured in terms of money. Examples, goodwill, trade marks, patent rights etc.

(iii) **Nominal accounts** : Nominal accounts are opened in the books to explain the nature of the transactions. For example, in a business salary is paid to the employees, rent is paid to the landlord, wages is paid to the workers, commission is paid to the salesmen, then in fact cash goes out of the business, that is real, but salary, rent, wages, commission etc. as such do not exist. These accounts are opened to explain how the cash has been spent. Nominal accounts includes accounts of all expenses, losses, income and gains.

The following list indicates a few more usual accounts coming under each category:

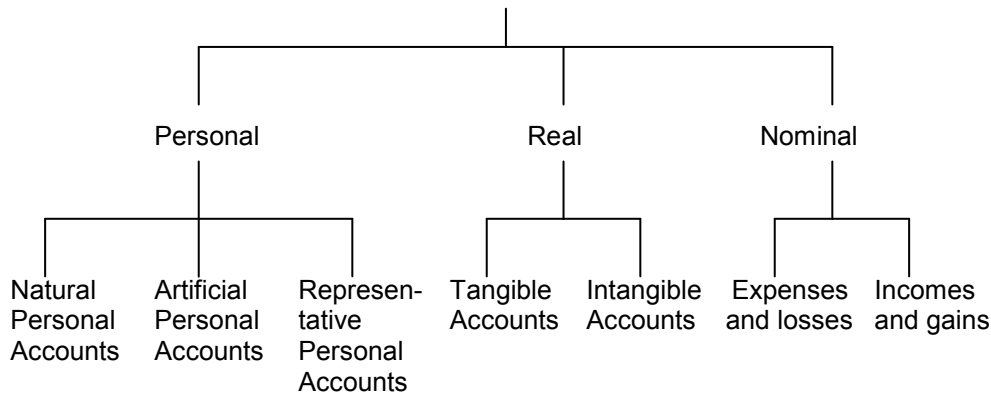
Personal accounts : (i) Bank (an artificial person); (ii) Tata Iron & Steel Co. (a company); (iii) Santosh (an individual); (iv) Capital (Rajesh-owner); (v) Bank loan (an artificial person); (vi) Rent outstanding (representative personal account).

Real accounts : (i) Plant and machinery; (ii) Investment; (iii) Land and building; (iv) Stock in hand; (v) Bills receivable; (vi) Trade marks; (vii) Cash.

Nominal accounts : (i) Interest; (ii) Salaries; (iii) Rent; (iv) Carriage; (v) Commission received; (vi) Insurance; (vii) Discount received; (viii) Wages.

Accounts can be classified as follows:

Accounts



Valuation accounts : In addition to the traditional classification of accounts - personal and impersonal - valuation accounts are also being recognised e.g. provision for depreciation account, provision for doubtful debts account, stock reserve account etc. Valuation accounts are also known as Contra accounts.

18. RULES OF DEBIT AND CREDIT

The two sides of any account are arbitrarily distinguished. The left side of an account is called the debit side; the right side is called the credit side. An entry on the left side of an account is called a debit entry, or merely a debit, an entry on the right side is called a credit entry or credit. The act of recording an entry on the left side of an account is called debiting the account; and recording an entry on the right side of an account is called crediting the account. The difference between the total debits and total credits is the account balance.

Double entry system means the recording of both the aspects i.e., receiving of values and giving of values of each transaction. The two aspects are distinguished in terms of debit and credit. An account is capable of receiving and giving of values. When an account receives a value or benefit it is debited and when it gives a value or benefit, it is credited. As every transaction affects at least two accounts, one account receives a benefit of certain value, another account would give the benefit of the same value.

Rules have been framed for the correct debit and credit of personal, real and nominal accounts:

- (1) **Personal Accounts** : 'Debit the receiver and credit the giver', i.e. Debit the account of the person who receives something and credit the account of the person who gives something. For example, if you purchase goods from Ram, on credit, the two accounts involved are Goods (Purchase) Account and Ram's Account. The latter account is a personal account. Since, Ram is the giver in this transaction his account will be credited. Similarly, if cash is paid to Ram, Ram's Account will be debited since he is the receiver. Thus, the account of a person is debited with any benefit such person receives and is credited with any benefit such person imparts.
- (2) **Real Accounts** : 'Debit what comes in, and credit what goes out', i.e. debit the account of the thing which comes in and credit the account of the thing which goes out. For example, where a furniture is purchased for cash, furniture account is debited while cash account should be credited.
- (3) **Nominal Accounts** : 'Debit all expenses and losses and credit all incomes and gains' i.e. debit the accounts of expenses and losses and credit all incomes and gains. For example, if you pay salary to your clerk, the two accounts involved are salary account and cash account. Salary account is a nominal account. Salary paid is an expense of the business and therefore this account, will be debited. Similarly if interest is received,

interest account will be credited, since interest is an income item.

If the three fundamental rules described above are kept in mind, it would be possible to record all the transactions correctly. You must have noted that if a transaction involves two accounts of different kinds then relevant positions of relevant rules will be applied. For example, payment of salary affects Salary Account and the Cash Account - the former is a nominal account whereas the latter is a real account. Hence, the former part of the third rule and the latter part of the second rule will be applicable, i.e., the rule will be: Debit all expenses and losses and Credit what goes out. Salary Account will be debited and Cash Account is credited.

It is to be noted here that it is not necessary that the record should be made only when actual amounts or goods or something tangible moves. A record is made even when an obligation arises.

Suppose a firm borrows Rs. 10,000 @ 12% per annum, at the end of the year Rs. 1,200 will be payable by way of interest. If the interest is actually paid; the entry will be, debit interest account and credit cash account. But suppose, cash has not yet been paid even then an entry will be made to record that the amount payable to the lender has increased by the amount of the interest. The entry will be to debit interest account and credit the lender. When later on, the amount of the interest is paid in cash, cash will be credited since the balance of the cash is reduced and the lender's account will be debited since the amount owing to him is also reduced.

Thus, rules of debit and credit may be summarised as follows:

Rules of Debit and Credit

<i>Types of account</i>	<i>Account to be debited</i>	<i>Account to be credited</i>
1. Personal Account	Receiver	Giver
2. Real Account	What comes in	What goes out
3. Nominal Account	Expenses and losses	Income and gains

19. SIGNIFICANCE OF DEBIT AND CREDIT

(a) Debit in personal accounts

- (i) If the account is new, debit implies that the person whose account is being debited has become debtor of the business.
- (ii) If the account is already there and the person whose account is being debited as already a debtor of the business, the new debit implies that the due from that person has increased.

If the account of a person who is a creditor of the business is debited, the debit implies that the amount due to that person has decreased by the amount of debit. It is also conceivable that the creditor may become a debtor after a debit entry; it will happen when the amount of the debit exceeds the amount for which the person was a creditor immediately before the debit.

(b) Credit in personal accounts

- (i) If the account is new, credit implies that the person whose account is being credited has become creditor of the business.
- (ii) If the account of a creditor of the business is credited it will mean that the amount which is due to that person has increased by the amount of the fresh credit. Credit in the account of a debtor of the business signifies that the amount for which the debtor was liable to the business has diminished by the amount of the credit entry. It is also possible that a debtor may become a creditor after the credit.

- (c) *Debit in real accounts* : A debit in real account means that either the value of the asset whose account is being debited has increased or the business has acquired more of that asset.
- (d) *Credit in real accounts* : A credit in the real account implies that either the value of the asset whose account is being credited has decreased or the business has disposed off part or the whole of the asset for the amount of the credit.
- (e) *Debit in nominal accounts* : A debit in nominal account signifies that there has been an expense or loss of the amount of the debit or some income or profit has diminished by the amount of the debit.
- (f) *Credit in nominal accounts* : A credit in a nominal account implies that there has been an income or a profit of the amount of credit or some expense or loss has diminished by the amount of the credit.

Example : From the following transactions, state the nature of accounts and state which account will be debited and which account will be credited?

Jan.1 Mr. Anil started business with Rs. 60,000.

Accounts involved:	(i) Cash Account;	(ii) Capital Account.
(i) Cash Account	Real	Debit (Incomings)
(ii) Capital Accounts	Personal	Credit (Giver)

Jan. 2 Purchased goods for cash Rs. 25,000.

Accounts involved:	(i) Purchases Account;	(ii) Cash Account.
(i) Purchases Account	Real	Debit (Incomings)
(ii) Cash Account	Real	Credit (Outgoings)

Jan. 5 Sold goods for cash Rs. 20,000.

Accounts involved:	(i) Cash Account;	(ii) Sales Account.
(i) Cash Account	Real	Debit (Incomings)
(ii) Sales Account	Real	Credit (Outgoings)

Jan. 8 Purchased goods from Mr. Bansal for cash Rs. 10,000.

Accounts involved:	(i) Purchases Account;	(ii) Cash Account.
(i) Purchases Account	Real	Debit (Incomings)
(ii) Cash Account	Real	Credit (Outgoings)

Jan. 15 Sold goods to Mr. Charles Rs. 8,000 on credit.

Accounts involved:	(i) Charles Account;	(ii) Sales Account.
(i) Charles Account	Personal	Debit (Receiver)
(ii) Sales Account	Real	Credit (Outgoings)

Jan. 16 Purchased furniture for Rs. 6,000

Accounts involved:	(i) Furniture Account;	(ii) Cash Account.
(i) Furniture Account	Real	Debit (Incomings)
(ii) Cash Account	Real	Credit (Outgoings)

Jan. 31 Paid rent Rs. 1,500

Accounts involved:	(i) Rent Account;	(ii) Cash Account.
(i) Rent Account	Nominal	Debit (Expenses)
(ii) Cash Account	Real	Credit (Outgoings)

Illustration 1

From the following transactions, state the nature of account and also state which account will be debited and which account will be credited:

- (i) X started business with cash
- (ii) Paid wages
- (iii) Purchased goods for cash
- (iv) Purchased goods from Ajit on credit
- (v) Purchased machinery for cash
- (vi) Interest paid
- (vii) Dividend received
- (viii) Machinery sold
- (ix) Outstanding for salaries.

Solution:

<i>Sl. No.</i>	<i>Accounts affected</i>	<i>Nature of account</i>	<i>Effect on business</i>	<i>Accounts debited/credited</i>
(i)	Cash A/c	Real A/c	Cash comes in	Dr.
	Capital A/c	Personal A/c	Proprietor is the giver	Cr.
(ii)	Wages A/c	Nominal A/c	Wages is an expense	Dr.
	Cash A/c	Real A/c	Cash goes out	Cr.
(iii)	Purchases A/c	Real A/c	Goods comes in	Dr.
	Cash A/c	Real A/c	Cash goes out	Cr.
(iv)	Purchases A/c	Real A/c	Goods comes in	Dr.
	Ajit's A/c	Personal A/c	Ajit the giver	Cr.
(v)	Machinery A/c	Real A/c	Machinery comes in	Dr.
	Cash A/c	Real A/c	Cash goes out	Cr.
(vi)	Interest A/c	Nominal A/c	Interest is an expense	Dr.
	Cash A/c	Real A/c	Cash goes out	Cr.
(vii)	Cash A/c	Real A/c	Cash comes in	Dr.
	Dividend A/c	Nominal A/c	Dividend received is a gain	Cr.
(viii)	Cash A/c	Real A/c	Cash comes in	Dr.
	Machinery A/c	Real A/c	Machinery goes out	Cr.
(ix)	Salaries A/c	Nominal A/c	Salary is an expense	Dr.
	Outstanding Salaries A/c	Personal A/c	Salaries have to be paid	Cr.

20. ACCOUNTING EQUATION

All business transactions are recorded as having a dual aspect. At any point of time a firm will possess things which may either be sold or converted into cash or which may be later used for a fairly long time. All these things are called assets. Building, land, machinery, furniture, stock, debtors, bills receivable, cash at bank, cash in hand etc. are a few examples of assets. The proprietor of the business brings capital into the business out of which the business (a separate entity) purchases assets for its use. Thus the amount of the assets of a business is equal to the amount of capital contributed by the proprietor of the business. Thus Capital = Assets.

In case the capital contributed by the proprietor is insufficient, the business takes borrowing from other parties or outsiders. These parties may give loan or allow credit facilities at the time of purchase of goods. All money which are owed to outsiders and which have to be paid, sooner or latter are called liabilities. On the one hand, the loan given by the outside parties increases the assets of the business, on the other hand, claims of creditors and lender of money on the assets of the business increase. Hence the sum of resources (assets) and obligations (capital + liabilities) must be equal. Therefore,

$$\begin{aligned} \text{Capital} + \text{Liabilities} &= \text{Assets}; \text{ or} \\ \text{Capital} &= \text{Assets} - \text{Liabilities}. \end{aligned}$$

This equation is known as accounting equation. This equation can be elaborated as follows:

Capital + Liabilities	=	Assets
↓		↓
Proprietor's capital		Land
+		Building
Loans		Machinery
Bank overdraft		Furniture
Creditors		Stock in trade
Bills payable		Debtors
Outstanding expenses		Bills receivable
Incomes in advances		Cash at bank
		Cash in hand

For example, suppose A starts business with a capital of Rs. 50,000, immediately the firm will have Rs. 50,000 as cash as asset and at the same time the firm will owe to the owner Rs. 50,000 which is taken as the proprietors' capital. Thus,

$$\text{Capital (Rs. 50,000)} = \text{Assets Rs. 50,000 (Cash)}.$$

If the firm purchases furniture worth Rs. 10,000 out of the money provided by A, the situation will be:

$$\text{Capital (Rs. 50,000)} = \text{Cash (Rs. 40,000)} + \text{Furniture (Rs. 10,000)}.$$

Subsequently, if the business borrows Rs. 15,000 from a bank, the position will be as follows:

$$\begin{aligned} \text{Capital (Rs. 50,000)} + \text{Bank loan (Rs. 15,000)} &= \text{Cash (Rs. 55,000)} + \\ \text{Furniture (Rs. 10,000)}. \end{aligned}$$

Thus, the equation can be technically stated as for every debit, there is an equivalent credit. As a matter of fact, the entire system of double entry book-keeping is based on this concept.

SELF-TEST QUESTIONS

1. Define accounting and state its attributes.
2. Name the users of accounting information.
3. Discuss the system of accounting.
4. Distinguish between book-keeping and accounting
5. State the difference between accounting concepts and conventions.
6. Discuss the merits of double entry system of accounting.

7. Explain the basic rules of debit and credit in accounting.
8. What do you mean by accounting equation?
9. Define the term 'account' and classify the following into personal, real and nominal account:
 - (i) Stationery Account
 - (ii) Depreciation Account
 - (iii) Cash Account
 - (iv) Bank Current Account
 - (v) Goodwill Account
 - (vi) Interest Account
 - (vii) Patents and Trade Marks Account
 - (viii) Capital Account
 - (ix) Bank Loan Account
 - (x) Freight Account
 - (xi) Drawings Account
 - (xii) Rent Account
 - (xiii) Account of Govind, a customer

Ans. [Personal: (iv), (viii), (ix), (xi), (xiii); Real: (iii), (v), (vii); Nominal: (i), (ii), (vi), (x), (xii)].

10. A firm spends money for the following. Mention whether they are Assets, Expenses or Losses:
 - (i) Purchasing typewriters
 - (ii) Acquiring trade marks
 - (iii) Paying salaries
 - (iv) Acquiring a lease of land for 15 years
 - (v) Paying interest
 - (vi) Purchasing furniture
 - (vii) Paying compensation to injured workers
 - (viii) Theft by burglars

Ans. [Assets: (i), (ii), (iv) and (vi); Expense: (iii), (v); Loss: (vii), (viii)].

11. Point out the accounts which will be debited and credited for each one of the following transactions:
 - (i) Cash received from X and discount allowed to him.
 - (ii) Cash paid to Y and discount received from him.
 - (iii) Credit Sales to Z.
 - (iv) Cash Sales to A.
 - (v) Purchases from B on credit.
 - (vi) Salary paid to clerk by means of cheque.
 - (vii) Payment of cash to Landlord for rent.
 - (viii) Depreciation on furniture.
 - (ix) Interest due but not yet paid.
 - (x) Interest provided on capital.

Ans. (i) Debit Cash Account and Discount and Credit X.
 (ii) Debit Y, Credit Cash Account and Discount Account.
 (iii) Debit Z, Credit Sales Account.
 (iv) Debit Cash Account and Credit Sales Account.
 (v) Debit Purchases Account and Credit B.
 (vi) Debit Salary Account and Credit Bank Account.
 (vii) Debit Rent Account and Credit Cash Account.

- (viii) Debit Depreciation Account and Credit Furniture Account.
- (ix) Debit Interest Account and Credit Interest Outstanding Account.
- (x) Debit Interest on Capital Account Credit Capital Account.

Suggested Readings :

- (1) *M.C. Shukla, T.S. Grewal and S.C. Gupta* — Advanced Accounts, Vol. I
 - (2) *S.N. Maheshwari* — Financial Accounting
 - (3) *J.R. Monga* — Advanced Financial Accounting
 - (4) *R.L. Gupta and V.K. Gupta* — Financial Accounting
 - (5) *S.P. Jain and K.L. Narang* — Financial Accounting
-

STUDY II

RECORDING OF TRANSACTIONS

1. ACCOUNTING CYCLE

Accounting cycle includes the following:

- 1. *Recording* : In the first instance, all transactions should be recorded in the journal or subsidiary books as and when they take place.
- 2. *Classifying* : All entries in the journal or subsidiary books are posted to the appropriate ledger accounts to find out at a glance the total effect of all such transactions in a particular account.
- 3. *Summarising* : The last stage is to prepare the trial balance and final accounts with a view to ascertain the profit or loss made during a particular period and the financial position of the business on a particular date.

2. JOURNAL

The journal is the book of prime entry in which every transaction is recorded before being posted into the ledger. It is that book of account in which transactions are recorded in a chronological (day to day) order. In modern times, besides the main journal, specialised journals are maintained to record different type of transactions.

For example, in Purchases Book (also called Purchases Journal) only credit purchases of goods-in-trade are recorded, whereas in Sales Book or Sales Journal only credit sales of goods-in-trade are recorded. Thus, several separate books of prime entry have come into use for recording different type of transactions. Journal is used only for recording those transactions for which no special book exists.

While learning accountancy, it is very rewarding to know how the various transactions can be recorded in journal. If one can record all the transactions in journal correctly we can say that one has won more than half the battle. In the examinations also, frequently candidates are asked just to pass the journal entries for all the transactions given in a question although in actual practice

most of these transactions may not actually appear in journal.

The process of recording transaction in a journal is termed as journalising. A journal is generally kept on a columnar basis. It has the following five columns - (i) Date; (ii) Particulars; (iii) Ledger Folio; (iv) Amount (Debit); (v) Amount (Credit).

A specimen ruling of a journal is as under:

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
<i>(i)</i>	<i>(ii)</i>	<i>(iii)</i>	<i>(iv)</i>	<i>(v)</i>

- (i) **Date** : The date on which the transaction has taken place is recorded here. The year is written at the top of the date column of each page of the journal. Therefore, on the next line of the date column, the month and day of the first entry are written. Unless the month or year changes or until a new page is begun, neither the month nor the year is repeated on the page.
- (ii) **Particulars** : The two aspects of a transaction are recorded in this column i.e. the details regarding the accounts which have to be debited and credited. The name of the account(s) to be debited is entered at the extreme left of the particulars column next to the date column. The abbreviation 'Dr.' is written at the right end of the particulars column on the same line of the account debited. The name of the account to be credited is entered on the next line with a prefix 'To' and is intended to the right of the date column. A brief explanation of the transaction known as narration is written below the account titles of the transaction. Brevity in explanation is most desirable but at the same time narration should be as informative as possible. Finally, a thin line is drawn all through the particulars column to indicate that the entry of the transaction has been completed.
- (iii) **L.F. (Ledger Folio)** : This column records the page number in the ledger in which the accounts in the particulars column are transferred (posted).
- (iv) **Amount (Debit)** : The debit amount is recorded in the amount (Dr.) column opposite to the title of the account debited.
- (v) **Amount (Credit)** : The credit amount is recorded in the amount (Cr.) column opposite to the title of the account credited.

The following procedure is followed for passing journal entries :

- (a) Each transaction is analysed in terms of accounts affected. As a rule every transaction has at least two accounts, corresponding to its giving and receiving aspects.
- (b) Find out the type of accounts affected in a transaction i.e., personal, real or nominal.
- (c) Apply the rules of debit and credit to each type of affected accounts.
- (d) The equality of debit and credit must be established. Sometimes, a journal entry may have more than one debit or more than one credit. This type of journal entry is called compound journal entry. Regardless of the number of debits or credits in a compound journal entry all debits are entered before any credits are entered. The aggregate amount of debits should be equal to the aggregate amount of credits.
- (e) For a business, journal entries generally extend to several pages, hence, totals of amount columns are cast at the end of each page. Against the debit and credit total at

the end of a page, the words, 'Total c/f' (c/f - indicates carried forward) are written in the particulars column. The debit and credit totals are then written in the beginning of the next page in the amount columns and against them the words 'Total b/f' (b/f - indicates brought forward) are written in the particulars column. On the last page 'Grand Total' is cast.

Compound Journal Entry : Transactions which are inter-connected and have taken place simultaneously are recorded by means of a compound or combined journal entry. For example receipt of cash from a debtor and allowance of discount to him are recorded by means of a single journal entry. Similarly transactions of the same nature are recorded by means of a combined entry provided they take place the same day. For example, if amount is spent on the same day for salaries, wages, stationery, rent, etc. a combined entry can be passed debiting all the relevant nominal accounts with respective amounts and crediting cash account with the total amount spent. There are cases (which will be known to you later on) where a compound entry is passed even for transactions of like nature which have taken place on different dates. This happens when the details of a particular type of transactions are recorded separately but journal entries are passed only periodically with the total amounts of those transactions.

Illustration 1

Journalise the following transactions:

		Rs.
2007		
April, 1	Rajesh starts business with cash	20,000
" 2	He buys goods for cash	15,000
" 4	He buys goods from Malhotra on credit	6,000
" 5	Furniture is purchased for cash	1,000
" 9	Cash sales made	1,500
" 11	Goods sold on credit to Satya Dev	4,000
" 16	Payment made to Malhotra	6,000
" 19	Cash sales	4,300
" 21	Purchase of stationery for cash	120
" 25	Sales on credit to Yusuf	1,770
" 30	Rent for the month paid in cash	1,500
" 30	Cash received from Satya Dev on Account	2,000

Solution:

Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
2007				
April, 1	Cash Account	Dr.	20,000	
	To Rajesh's Capital Account			20,000
	(Cash brought in by Rajesh, the proprietor, as his capital)			
	Total c/f		20,000	20,000
Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)

2007

April Total b/f 20,000 20,000

" 2 Purchases Account Dr. 15,000
To Cash Account 15,000

(Goods in trade purchased for cash)

" 4 Purchases Account Dr. 6,000
To Malhotra 6,000

(Goods purchased on credit, Malhotra being the supplier)

" 5 Furniture Account Dr. 1,000
To Cash Account 1,000

(Purchase of furniture for cash)

" 9 Cash Account Dr. 1,500
To Sales Account 1,500

(Cash sales made)

" 11 Satya Dev Dr. 4,000
To Sales Account 4,000

(Goods sold on credit to Mr. Satya Dev)

" 16 Malhotra Dr. 6,000
To Cash Account 6,000

(Payment made to Malhotra to clear his account)

" 19 Cash Account Dr. 4,300
To Sales Account 4,300

(Cash sales of goods made this day)

" 21 Stationery Account Dr. 120
To Cash Account 120

(Cash paid to buy stationery)

Total c/f 57,920 57,920

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
------	-------------	------	----------------	-----------------

Total b/f 57,920 57,920

2007

April, 25 Yusuf Dr. 1,770
To Sales Account 1,770

(Sales made to Rajesh on credit)

" 30 Rent Account Dr. 1,500
To Cash Account 1,500

(Rent paid in cash)

"	30	Cash Account	Dr.	2,000	
		To Satya Dev			2,000
		(Cash received from Satya Dev on account)			
		Total		<u>63,190</u>	<u>63,190</u>

Illustration 2

Journalise the following transactions:

2007				Rs.
Mar.,	2	Commenced business with cash		2,50,000
"	4	Purchased furniture for cash		20,000
"	4	Cash purchases		1,45,000
"	5	Deposited with bank		30,000
"	6	Bought from Patil		40,000
		Sold to Natarajan for cash		14,300
"	7	Stationery purchased		1,050
"	7	Bought from Salil		26,000
"	7	Sold to Mukherjee		8,080
"	9	Rent for two years paid in advance		24,000
"	9	Drawings by the proprietor for household expenses		4,000
		Goods taken out by the proprietor for domestic use		500
"	9	Cash withdrawn from Bank		25,000
"	10	Sold to Mathur on credit		9,850
"	11	Purchases made, payment through cheque		2,900
"	14	Cash received from Patil on account		10,000
"	14	Cash paid to Salil after deduction of discount Rs. 1300		24,700
"	17	Cash received from Mathur in full settlement of his account		9,750
2007				Rs.
Mar.,	18	Mukherjee becomes insolvent. A dividend of 50 paise in a rupee is received		4,040
"	18	Purchase of a Scooter for cash		30,000
"	20	Sold goods to Aggarwal		8,640
		Sold to Nayak		3,780
"	24	Cartage paid in cash		150
"	24	Repairs to Scooter, payment not yet made		170
"	26	Payment of cash for petrol		550
"	26	Purchases of goods for cash		12,000
"	26	Purchases of Office Equipment for cash		12,100
"	27	Repairs bill paid in cash		170
"	28	Aggarwal returns goods		400
"	31	Depreciation in furniture		100
		Depreciation on Scooter		200
"	31	Salary to clerk outstanding		1,800
"	31	Adjustment for the month's rent		1,000
"	31	Bank charges for the month		50
"	31	Interest on capital for the month		1,250
		Salary to be credited to proprietor		2,000

- " 31 Salil agrees to take some defective goods purchased from him and immediately refunds the money 700

Solution :

JOURNAL

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit Rs.</i>	<i>Credit Rs.</i>
2007			Rs.	Rs.
Mar., 2	Cash Account Dr. To Capital Account (For cash brought in by proprietor as his capital)		2,50,000	2,50,000
" 4	Furniture Account Dr. To Cash Account (For purchase of furniture for cash)		20,000	20,000
" 4	Purchases Account Dr. To Cash Account (For purchase of goods in trade for cash)		1,45,000	1,45,000
" 5	Bank Account Dr. To Cash Account (For cash deposited in bank)		30,000	30,000
	Total c/f		4,45,000	4,45,000
<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit Rs.</i>	<i>Credit Rs.</i>
	Total b/f		4,45,000	4,45,000
2007				
Mar., 6	Purchases Account Dr. To Patil (For credit purchases of goods in trade, Patil being the supplier)		40,000	40,000
" 6	Cash Account Dr. To Sales Account (For cash sales made to Natarajan)		14,300	14,300
" 7	Stationery Account Dr. To Cash Account (For purchase of stationery for cash)		1,050	1,050
" 7	Purchases Account Dr. To Salil (For credit purchases of goods to Salil)		26,000	26,000
" 7	Mukherjee Dr. To Sales Account (For credit sales of goods to Mukherjee)		8,080	8,080
" 9	Rent Paid in Advance A/c Dr. To Cash Account (For rent paid in advance)		24,000	24,000

" 9	Drawings Account	Dr.	4,500	
	To Cash Account			4,000
	To Purchases Account			500
	(For drawings in cash and goods made by the proprietor)			
" 9	Cash Account	Dr.	25,000	
	To Bank Account			25,000
	(For cash withdrawn from Bank)			
" 10	Mathur	Dr.	9,850	
	To Sales Account			9,850
	(For sales to Mathur on credit)			
	Total c/d		5,97,780	5,97,780
<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit Rs.</i>	<i>Credit Rs.</i>
	Total b/f		5,97,780	5,97,780
2007				
Mar., 11	Purchases Account	Dr.	2,900	To
	Bank Account	2,900		
	(For purchases of goods, payment made by means of cheque)			
" 14	Cash Account	Dr.	10,000	
	To Patil			10,000
	(For cash received from Patil)			
" 14	Salil	Dr.	26,000	
	To Cash Account			24,700
	To Discount Account			1,300
	(For cash paid to Salil and discount received from him)			
" 17	Cash Account	Dr.	9,750	
	Discount Account	Dr.	100	
	To Mathur			9,850
	(For cash received from Mathur and discount allowed)			
" 18	Cash Account	Dr.	4,040	
	Bad Debts Account	Dr.	4,040	
	To Mukherjee			8,080
	(For cash received from Mukherjee on his insolvency and amount written off as bad debt)			
" 18	Scooter Account	Dr.	30,000	
	To Cash Account			30,000
	(For purchase of a scooter)			
" 20	Aggarwal	Dr.	8,640	
	Nayak	Dr.	3,780	
	To Sales Account			12,420

		(For credit sales made to Aggarwal and Nayak on this day)			
"	24	Cartage Account	Dr.	150	
		To Cash Account			150
		(Cartage paid)			
		Total c/f		6,97,180	6,97,180
<i>Date</i>		<i>Particulars</i>	<i>L.F.</i>	<i>Debit Rs.</i>	<i>Credit Rs.</i>
		Total b/f		6,97,180	6,97,180
2007					
Mar.,	24	Repairs Account	Dr.	170	
		To Repairs Outstanding A/c			170
		(For repairs charges, outstanding)			
"	26	Petrol Expense Account	Dr.	550	
		To Cash Account			550
		(For petrol expenses paid in cash)			
"	26	Purchases Account	Dr.	12,000	
		To Cash Account			12,000
		(For cash purchases)			
"	26	Office Equipment Account	Dr.	12,100	
		To Cash Account			12,100
		(For purchase of office equipment)			
"	27	Repairs Outstanding A/c	Dr.	170	
		To Cash Account			170
		(Repairs outstanding paid)			
"	28	Sales Returns Account	Dr.	400	
		To Aggarwal			400
		(Sales returns from Aggarwal)			
"	31	Depreciation Account	Dr.	100	
		To Furniture Account			100
		(For depreciation on furniture)			
"	31	Depreciation Account	Dr.	200	
		To Scooter			200
		(For depreciation on scooter)			
"	31	Salary Account	Dr.	1,800	
		To Salary Outstanding A/c			1,800
		(For salary outstanding)			
"	31	Rent Account	Dr.	1,000	
		To Rent Outstanding A/c			1,000
		(For rent outstanding)			
		Total c/f		7,25,670	7,25,670

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit Rs.</i>	<i>Credit Rs.</i>
	Total b/f		7,25,670	7,25,670
2007				
Mar., 31	Bank Charges Account To Bank (For bank charges)	Dr.	50	50
" 31	Interest on Capital A/c Salary to Proprietor To Capital Account (For interest on capital, Rs. 1250 and salary for the proprietor credited with Rs. 2,000)	Dr. Dr.	1,250 2,000	3,250
"	Cash Account To Purchase Returns A/c (For cash received from Salil on return of some defective goods sold to him)	Dr.	700	700
	Total		<u>7,29,670</u>	<u>7,29,670</u>

2. LEDGER - PRINCIPAL BOOK OF ACCOUNTS

The ledger is the principal book of accounts where similar transactions relating to a particular person or property or revenue or expense are recorded. In other words, it is a set of accounts. It contains all accounts of the business enterprise whether real, nominal or personal. The main function of a ledger is to classify or sort out all the items appearing in the journal or other subsidiary books under their appropriate accounts so that at the end of the accounting period each account will contain the entire information of all the transactions relating to it in a summarised or condensed form. For instance, all the transactions that have taken place with Mr. Mathur have been entered in Mathur's Account. Similarly, all items relating to cash, sales, purchases, salaries, discount, etc. appear in their respective accounts. Hence the ledger helps in finding out the combined effect of entries for each individual account and also for the entire business. The following is the specimen ruling of the standard form of ledger account.

Dr.				Cr.			
Name of Account							
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.

The following are the important features of the ledger account cited above:

- The ledger account is divided into two sides - the left hand side is known as debit side while the right hand side is known as credit side. The abbreviations 'Dr.' and 'Cr.' are placed at the top left and right hand corners respectively. This is more by custom than under any law.
- The name of account is written in the middle of the account.
- J.F. denotes folio or page number on which its journal entry may be found.

Relationship between Journal and Ledger

Both Journal and Ledger are the important books used under double entry system of book keeping. The following are the points of comparison between the two:

- (i) The transactions are recorded first in the journal and then they are posted to the ledger. Thus journal is the book of first or original entry while the ledger is the book of second entry.
- (ii) The journal is the book for chronological record while the ledger is the book for the analytical record.
- (iii) Journal is more reliable as compared to the ledger since it is the book in which the entry is passed first.
- (iv) The process of recording transaction is termed as "Journalising" while the process of recording transactions in the ledger is known as 'Posting'.

4. LEDGER POSTING

The term 'Posting' means transferring the debit and credit items from the journal to their respective accounts in the ledger. It may be noted that the exact names of accounts used in the journal should be carried to the ledger. The following rules should be observed while posting transactions in the ledger from the journal:

- (i) Separate accounts should be opened in the ledger for posting transactions relating to different accounts recorded in the journal.
- (ii) The concerned account which has been debited in the journal should also be debited in the ledger i.e., the debit of the journal entry is posted to the debit side. However, a reference should be made of the other account which has been credited in the journal.
- (iii) The concerned account which has been credited in the journal, should also be credited in the ledger i.e., the credit of the journal entry is posted to the credit side, but a reference should be given of the other account which has been debited in the journal.
- (iv) It is customary to use the words 'To' and 'By' while making posting in the ledger. The words 'To' is used with the accounts shown on the debit side of the ledger account while the word 'By' is used with accounts which appear on the credit side of the ledger account.
- (v) In the folio column, the page number of the journal from where the entry is transferred to ledger account is written.
- (vi) The date of the transaction is written on the date column.

Illustration 3

Journalise the following transactions:

- (i) March 1, 2007 - Purchased furniture on credit from Fancy Furniture Stores Rs. 57,000.
- (ii) March 10, 2007 - Special Allowance allowed to N.C. Mehta for defect in goods sold to him Rs. 1,300.
- (iii) March 29, 2007 - Mathur from whom Rs. 10,000 were to be received is declared insolvent. A cheque of Rs. 2,500 is received from official receiver as the first and final dividend.

Solution:

Journal Entries

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit Rs.</i>	<i>Credit Rs.</i>
2007				
March 1	Furniture Account	Dr.	57,000	

		To Fancy Furniture Stores (For credit purchases of furniture from Fancy Furniture Stores)		57,000
"	10	Sales Account	Dr.	1,300
		To N.C. Mehta (For special allowance to N.C. Mehta for defect in goods sold to him)		1,300
"	29	Bad Debts Account	Dr.	7,500
		To Mathur (Bad debt written off on Mathur's insolvency)		7,500

*Rs. 2,500, cheque received on March 29 will be entered in the Cash Book.

Posting of above mentioned journal entries will be made as under:

**Ledger Accounts
Furniture Account**

Dr.				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007							
Mar. 1	To Fancy Furniture Stores		57,000				

Fancy Furniture Stores Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2007			Rs.
				Mar. 1	By Furniture		57,000

Sales Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007			Rs.				
Mar. 10	To N.C. Mehta		1,300				

N.C. Mehta

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2007			Rs.
				Mar. 10	By Sales Account		1,300

Bank Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007			Rs.				
Mar. 29	To Mathur		2,500				

Bad Debts Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007			Rs.				
Mar. 29	To Mathur		7,500				

Mathur

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2007			Rs.
				Mar. 29	By Bank		2,500*
				"	By Bad Debts A/c		7,500

*From the Cash Book.

5. BALANCING LEDGER ACCOUNTS

Balancing of an account means the process of equalising the two sides of an account by putting the difference on the side where amount is short. Where the debit side of an account exceeds the credit side then the difference is put on the credit side, and the account is said to have a debit balance. This balance is brought down on the debit side while opening the account. Similarly, where the credit side of an account exceeds the debit side, the difference is put on the debit side, and the account is said to have a credit balance. This is also brought down on credit side while opening the account. The following steps are followed for balancing the accounts:

- Total the amounts of debit and credit entries in the account.
- If the debit and credit sides are equal then there is no balance. The account stands automatically balanced or closed.
- If the debit side total is more, put the difference on the credit side amount column, by writing the words in particulars column "By Balance c/d". If the credit side total is more, put the difference on the debit side amount column by writing the words in the particulars column "To Balance c/d".
- After putting the difference in the appropriate side of the account, add both sides of the account and draw a thin line above and below the total.
- Bring down the debit balance on the debit side by writing the words in particulars column "To Balance b/d". Similarly bring down the credit balance on the credit side by writing the words in the particulars column "By Balance b/d".

The debit balance of an account may represent either an asset or an expense. If such balance relates to a Personal Account it reflects debtors; if it relates to Real Accounts, it is a property, if it relates to a Nominal Account it is an expense or loss. Similarly credit balance of an account represents either a liability or a gain. If such balance relates to a Personal Account, it is a creditor, if it relates to a Nominal Account, it is a gain or income. Real Accounts usually shows debit balance. In case there is a credit balance in a Real Account, it reflects loss on sale of the asset. It may be noted that when Nominal Accounts are balanced on the last day of an accounting year their balances are not carried down but are transferred to Trading and Profit and Loss Account.

Illustration 4

Journalise the following transactions, post them in the ledger and balance the accounts in the books of Mr. Rajesh.

			Rs.
2007			
Jan. 1	Started business with cash		2,00,000
Jan. 3	Purchased goods for cash		60,000
Jan. 5	Sold goods to Shyam		60,000
Jan. 6	Sold goods for cash		20,000
Jan. 9	Received cash from Shyam		40,000
Jan. 13	Goods purchased from Ram		40,000
Jan. 20	Cash paid to Ram		20,000
Jan. 25	Paid office rent		4,000
Jan. 31	Paid salaries to staff		20,000
Jan. 31	Returned goods by Shyam		10,000

Solution :

**In the Books of Mr. Rajesh
Journal Entries**

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit Rs.</i>	<i>Credit Rs.</i>
2007				
Jan. 1	Cash Account To Capital Account (Being capital introduced by the proprietor in cash)	Dr.	2,00,000	2,00,000
	<u>Total c/f</u>		<u>2,00,000</u>	<u>2,00,000</u>
<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit Rs.</i>	<i>Credit Rs.</i>
	Total b/f		2,00,000	2,00,000
Jan., 3	Purchases Account To Cash Account (Being goods purchased for cash)	Dr.	60,000	60,000
	<u>Total c/d</u>		<u>2,60,000</u>	<u>2,60,000</u>
" 5	Shyam To Sales Account (Being goods sold on credit to Shyam)	Dr.	60,000	60,000
" 6	Cash Account To Sales Account (Being goods sold for cash)	Dr.	20,000	20,000
" 9	Cash Account To Shyam (Being the cash received from Shyam)	Dr.	40,000	40,000
" 13	Purchases Account To Ram (Being goods purchased on credit from Ram)	Dr.	40,000	40,000
" 20	Ram To Cash Account (Being cash paid to Ram)	Dr.	20,000	20,000
" 25	Rent Account To Cash Account (Being office rent paid in cash)	Dr.	4,000	4,000
" 31	Salaries Account To Cash Account (Being salaries paid to staff)	Dr.	20,000	20,000
" 31	Sales Returns Account To Shyam	Dr.	10,000	10,000

(Being goods returned by Shyam)

Total	<u>4,74,000</u>	<u>4,74,000</u>
	-----	-----

Ledger Accounts							
Cash Account							
Dr.							Cr.
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 1	To Capital A/c		2,00,000	Jan. 3	By Purchases A/c		60,000
" 6	To Sales		20,000	" 20	By Ram		20,000
" 9	To Shyam		40,000	" 25	By Rent A/c		4,000
				" 31	By Salaries A/c		20,000
				" 31	By Balance c/d		<u>1,56,000</u>
			<u>2,60,000</u>				<u>2,60,000</u>
Feb. 1	To Balance b/d		1,56,000				

Capital Account							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 31	To Balance c/d		<u>2,00,000</u>	Jan. 1	By Cash A/c		<u>2,00,000</u>
				Feb. 1	By Balance b/d		2,00,000

Purchases Account							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 3	To Cash A/c		60,000	Jan. 31	By Balance c/d		1,00,000
" 13	To Ram		<u>40,000</u>				
			<u>1,00,000</u>				<u>1,00,000</u>
Feb. 1	To Balance c/d		1,00,000				

Sales Account							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 31	To Balance c/d		80,000	Jan. 5	By Shyam		60,000
				" 6	By Cash A/c		<u>20,000</u>
			<u>80,000</u>				<u>80,000</u>
				Feb. 1	By Balance b/d		80,000

Shyam							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 5	To Sales Account		60,000	Jan. 9	By Cash A/c		40,000
				" 31	By Sales Returns		10,000
				" 31	By Balance c/d		<u>10,000</u>
			<u>60,000</u>				<u>60,000</u>

Feb. 1 To Balance b/d 10,000

<i>Dr.</i>				Ram				<i>Cr.</i>			
<i>Date</i>		<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>		<i>Particulars</i>	<i>J.F.</i>		<i>Rs.</i>	
2007					2007						
Jan.	20	To Cash Account		20,000	Jan.	13	By Purchases A/c			40,000	
"	31	To Balance c/d		<u>20,000</u>							
				<u>40,000</u>						<u>40,000</u>	
					Feb.	1	By Balance b/d			20,000	

Rent Account

<i>Date</i>		<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>		<i>Particulars</i>	<i>J.F.</i>		<i>Rs.</i>	
2007					2007						
Jan.	25	To Cash Account		<u>4,000</u>	Jan.	31	By Balance c/d			4,000	
				<u>4,000</u>							
Feb.	1	To Balance b/d		4,000							

Salaries Account

<i>Date</i>		<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>		<i>Particulars</i>	<i>J.F.</i>		<i>Rs.</i>	
2007					2007						
Jan.	31	To Cash Account		<u>20,000</u>	Jan.	31	By Balance c/d			20,000	
				<u>20,000</u>							
Feb.	1	To Balance b/d		20,000							

Sales Returns Account

<i>Date</i>		<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>		<i>Particulars</i>	<i>J.F.</i>		<i>Rs.</i>	
2007					2007						
Jan.	31	To Shyam		<u>10,000</u>	Jan.	31	By Balance c/d			10,000	
				<u>10,000</u>							
Feb.		To Balance b/d		10,000							

6. SUBSIDIARY BOOKS OF ACCOUNT

As stated earlier journal is a book of primary entry. It means all business transactions are to be first recorded in the journal. However, in big business houses recording of all transactions in one journal will not only be inconvenient but also cause delay in collecting the information required. The journal is, therefore, sub-divided into many subsidiary books. The sub-division of journal into various subsidiary journals, recording transactions of similar nature are called subsidiary books. The following are the special journals or subsidiary books:

1. Purchases Book
2. Sales Book
3. Purchases Returns Book
4. Sales Returns Book
5. Bills Receivable Book
6. Bills Payable Book
7. Cash Book.

7. PURCHASES BOOK

Purchases book is meant for recording the purchase of goods on credit. If any property other than goods is bought on credit, it should not be recorded in this book. Similarly, cash purchases are also not recorded in this book. The ruling of the purchases book is as follows:

Purchases Book

<i>Date</i>	<i>Particulars</i>	<i>Invoice No.</i>	<i>Ledger Folio</i>	<i>Details Rs.</i>	<i>Amount Rs.</i>

The posting is done in the personal account daily from the purchases book. At the end of week/month, the total of the purchases book is debited to the purchases account in the ledger.

In 'Particulars Column' the names of the suppliers together with details of goods purchases are recorded. In 'Details Column' amounts of different items are recorded whereas in 'Amount Column' the net amount of various invoices are recorded.

Illustration 5

The purchases of a firm are as follows:

10th March, 2007 from Moonlite & Co., Bombay;

50 Electric bulbs of 100 Wt. each @ Rs. 8 each.

5 Coolers @ Rs. 400 each.

Moonlite & Co., Bombay allows trade discount @ 10% (Trade discount is an allowance made by suppliers for bulk purchases).

On 15th March, 2007 office furniture from Equipments & Co. for Rs. 13,200 on credit.

On 18th March, 2007 from Prakash Chand & Sons, Surat:

10 toasters @ Rs. 600 each. Prakash Chand & Sons, Surat, allows trade discount @ 15%.

On 20th March, 2007, 100 cut-outs @ Rs. 50 each from Electric & Co. for cash.

Solution :

The abovementioned purchases will be recorded in the Purchases Book of the firm as follows:

Purchases Book

<i>Date</i>	<i>Particulars</i>	<i>Invoice No.</i>	<i>Ledger Folio</i>	<i>Details Rs.</i>	<i>Amount Rs.</i>
2007					
Mar. 10	To Moonlite & Co., Bombay				
	50 electric bulbs of 100 Wt.				
	@ 8/- each			400	
	5 Coolers @ Rs. 400 each			<u>2,000</u>	

			2,400	
	Less: Trade Discount 10%		<u>240</u>	2,160
Mar. 18	To Prakash Chand & Sons, Surat			
	10 Toasters @ Rs. 600 each		6,000	
	Less : Trade Discount 15%		<u>900</u>	<u>5,100</u>
				<u>7,260</u>

The purchases on 15th March will be journalised and that on 20th March will be entered in the Cash Book.

Entries in the Purchases Book are made from invoices received from suppliers. As far as posting in Purchases Book is concerned, the different suppliers' account are individually credited with their respective amounts but Purchases Account is debited only with the monthly totals of Purchases Book. Postings of the Purchases Book shown above will appear as follows:

Moonlite & Co., Bombay							
Dr.				Cr.			
Date	Particulars	JF	Rs.	Date	Particulars	JF	Rs.
			2006				
	Mar. 10		By Purchases		2,160		

Prakash Chand & Sons, Surat							
Date	Particulars	JF	Rs.	Date	Particulars	JF	Rs.
			2007				
			Mar. 10		By Purchases	PB12	5,100

Purchases Account							
Dr.				Cr.			
Date	Particulars	JF	Rs.	Date	Particulars	JF	Amount
2007			Rs.				
Mar. 30	To Sundries						
	as per						
	Purchases						
	Book	PB72	7,260				

Note : All folio numbers are assumed ones.

PB = Purchases Book.

8. SALES BOOK

In Sales Book, only credit sales of goods in trade are recorded. It is maintained on the lines similar to those on which Purchases Book is maintained. In 'Particulars Column, the name of the customers alongwith details of the goods sold to them are recorded. Sales Book is prepared on the basis of copies of invoice sent to customers. To post Sales Book, the accounts of the customers are individually debited with respective amounts at the end of every month. Sales

Account is credited with the monthly total of the Sales Book.

Cash Sales will be entered in the Cash Book; credit sale of various assets or investments will be journalised.

The following is a specimen of Sales Book:

Sales Book

<i>Date</i>	<i>Particulars</i>	<i>Invoice No.</i>	<i>Ledger Folio</i>	<i>Details Rs.</i>	<i>Amount Rs.</i>

Illustration 6

From the following transactions write up the Sales Day Book of M/s. X & Co.:
2007

- Jan. 1 Sold to Premier Traders 100 Bags of sugar @ Rs. 650 per bag, less trade discount @ 5%.
- Jan. 10 Sold to R & Co. 10 bags of milk powder @ Rs. 500 per bag, less trade discount @ 10%.
- Jan. 20 Sold to Tea King (P) Ltd. 10 Chest C.T.C. Tea @ Rs. 2,000 per Chest, less trade discount @ 10%.
- Jan. 29 Sold old office furniture on credit to Modern Furniture for Rs. 12,500.

**In the Books of M/s. X & Co.
Sales Book**

<i>Date</i>	<i>Particulars</i>	<i>Invoice No.</i>	<i>Ledger Folio</i>	<i>Details Rs.</i>	<i>Amount Rs.</i>
2007					
Jan. 1	Premier Traders 100 bags of sugar @ Rs. 650 per bag Less: Trade Discount @ 5%			65,000 <u>3,250</u>	 61,750
Jan. 10	R & Co. 10 bags of milk powder @ Rs. 500 per bag Less: Trade Discount @ 10%			5,000 <u>500</u>	 4,500
Jan. 20	Tea King (P) Ltd. 10 Chest C.T.C tea @ Rs. 2,000 per chest Less: Trade Discount @10%			20,000 <u>2,000</u>	 <u>18,000</u> <u>84,250</u>

Note: Sale of old furniture to be passed through Journal proper.

9. PURCHASES RETURNS BOOK

The purchase returns books records the details of goods returned by the business enterprise

to the supplier(s). The goods purchased for cash and returned are not recorded in this book. When the goods are returned to the supplier, a debit note is sent to him indicating that his account has been debited with the amount mentioned in the debit note. The specimen of the purchases returns book is as follows:

Purchase Returns Book

<i>Date</i>	<i>Particulars</i>	<i>Debit Note No.</i>	<i>Ledger Folio</i>	<i>Amount Rs.</i>	<i>Amount Rs.</i>
-------------	--------------------	---------------------------	-------------------------	-----------------------	-----------------------

The total amount column of the purchases return book is credited to the purchases returns account and the account of the supplier(s) or to whom debit notes have been sent are debited individually in their respective accounts.

10. SALES RETURNS BOOK

Goods may be returned by the customers for a variety of reasons such as wrong quantity and/or quality. Hence, the details of goods returned by the customers are recorded in this book. Goods sold for cash and returned do not find a place in sales returns book. When goods are returned by the customer a credit note is sent to him intimating that his account has been credited with the value of goods returned. A specimen of the sales returns book is as follows:

Sales Returns Book

<i>Date</i>	<i>Particulars</i>	<i>Credit Note No.</i>	<i>Ledger Folio</i>	<i>Amount Rs.</i>	<i>Amount Rs.</i>

The individual accounts of the customers are credited with their respective amounts while the periodical total of the amount column of the sales returns book is posted to the debit of sales returns account.

Illustration 7

Record the following transactions in the appropriate books of original entry and show how they will be posted. Assume invoice numbers, folio number, etc.

2007

- Mar. 6 Purchased on Credit from Kadam
 100 Shirts @ Rs. 300 each
 50 Neckties @ Rs. 100 each.
- Mar.10 Sold on Credit to Mehta
 10 Bush Shirts @ 350 each
 20 Hand towels @ Rs. 20 each.
- " 13 Goods returned to Kadam
 2 Shirts @ 300 each
- " 17 Sold to Andley on Credit
 20 Trousers @ Rs. 200 each
 5 Neck-ties @ Rs. 120 each
- " 18 Goods received back from Manohar, a customer

- 4 Nick-ties @ Rs. 110 each
 2 Shirts @ Rs. 500 each
 " 22 Sold to Apte on credit
 5 Bush Shirts @ Rs. 500 each
 100 metres of long cloth @ Rs. 30 per metre
 " 28 Apte returns 1 Bush Shirt invoiced at Rs. 500
 " 30 Purchased goods on credit from Gyani Cloth Store
 150 Bush Shirts @ Rs. 400 each
 200 metres of long cloth @ Rs. 25 per metre
 50 metres of shirting @ Rs. 150 per metre
 Gyani Cloth Store allows Trade Discount @ 5%
 Andley returns one Neck-tie invoiced at Rs. 120

Solution:

Purchases Book

<i>Date</i>	<i>Particulars</i>	<i>Inv. No.</i>	<i>L.F.</i>	<i>Details Rs.</i>	<i>Amount Rs.</i>
2007					
Mar. 6	Kadam 100 shirts Rs. 300 each 50 Nick-ties Rs. 100 each	62	8	30,000 <u>5,000</u>	35,000
Mar. 30	Gyani Cloth Store 150 Bush Shirts Rs.400 each 200 metre long cloth @ Rs. 25 per metre 50 metres Shirting @ Rs. 150 per metre Less : Trade Discount 5% Total	6981	17	60,000 <u>5,000</u> <u>7,500</u> 72,500 <u>3,625</u>	 <u>68,875</u> <u>1,03,875</u>

Sales Book

<i>Date</i>	<i>Particulars</i>	<i>Inv. No.</i>	<i>L.F.</i>	<i>Details Rs.</i>	<i>Amount Rs.</i>
2007					
Mar. 10	Mehta 10 Bush Shirts @ Rs. 350 each 20 Hand towels @ Rs. 20 each	408	9	3,500 <u>400</u>	 3,900
" 17	Andley 20 Trousers @ Rs. 200 each 5 Neck-ties	409	12	4,000	

	@ Rs. 120 each			<u>600</u>	4,600
" 22	Apte				
	5 Bush Shirts				
	@ Rs. 500 each	410	15	2,500	
	100 metre long cloth				
	@ Rs. 30 per metre			<u>3,000</u>	<u>5,500</u>
	Total				<u>14,000</u>

Purchases Returns Book

Date	Particulars	Debit Note No.	L.F.	Amount Rs.	Amount Rs.
2007					
Mar. 13	Kadam				
	2 Shirts	22	8		
	@ Rs. 300 each				<u>600</u>
	Total				<u>600</u>

Sales Returns Book

Date	Particulars	Credit Note No.	L.F.	Amount Rs.	Amount Rs.
2007					
Mar. 18	Manohar				
	4 Nick-ties @ Rs. 110 each	34	7	440	
	2 Shirts @ Rs. 500 each			<u>1,000</u>	1,440
" 28	Apte				
	1 Bush Shirts @ Rs. 500	35	15		500
" 30	Andley				
	1 Nick-tie @ Rs. 120	36	12		<u>120</u>
	Total				<u>2,060</u>

Ledger Accounts

Dr.				Cr.			
Kadam							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Mar. 13	To Purchase Returns A/c	(PRB 3)	600	Mar. 6	By Purchases A/c	(PB 8)	35,000

Mehta

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007							
Mar. 10	To Sales Account	(SB23)	3,900				

Dr.				Cr.			
Andley							
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.

2007				2007			
Mar. 17	To	Sales A/c	(SB 23) 4,600	Mar. 30	By	Sales Returns Account	(SRB 10) 120

Manohar

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
	Mar. 18						
				2007			
				Mar. 30	By Sales Returns A/c		(SRB 10) 1,440

Apte

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Mar. 22	To Sales Account	(SB 23)	5,500	Mar. 28	By Sales Returns Account	(SRB 10)	500

Gyani Cloth Stores Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2007			
				Mar. 30	By Purchases A/c	(PB8)	68,875

Sales Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2007			
				Mar. 31	By Sundries as per Sales Book (SB 23)		14,000

Purchase Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
Mar. 31	To Sundries as per Purchases Book	(PB 10)	1,03,875				

Purchases Returns Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2007			
				Mar. 31	By Sundries as per Purchases Returns Book	(PRB 3)	600

Sales Returns Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007							
Mar. 31	To Sundries as per Sales Returns Book	(SRB 10)	2,060				

11. BILLS RECEIVABLE BOOK

This book is used to record the details of bills receivable on which the business enterprise will receive the amounts from other parties in future. The entries to be made in this book include the name of the acceptor, date of receipt of the bill, the term, due date, the amount and other details. The total of the amount column of the bills receivable book is debited to bills receivable account while the amount of each bills receivable is posed to the credit of the account of the party from whom it is received. The following is the ruling of a bills receivable book.

Bills Receivable Book

<i>Bill No. (1)</i>	<i>Date Received (2)</i>	<i>From whom received (3)</i>	<i>Ledger Folio (4)</i>	<i>Acceptor (5)</i>

<i>Date of the Bill (6)</i>	<i>Term (7)</i>	<i>Due Date (8)</i>	<i>Amount (9)</i>	<i>Disposal (10)</i>

12. BILLS PAYABLE BOOK

This is used to record the particulars of all the bills payable accepted by the business enterprise for the purpose of paying at a future date amounts due by it to its creditors. The acceptance is duly returned to the drawer. The amount of each bill is posted to the debit side of the drawer's account in the ledger and the total of the amount column of the bills payable book is posted to the credit of bills payable account in the ledger. The following is the specimen of bills payable book:

Bills Payable Book

<i>Bill No. (1)</i>	<i>Date accepted (2)</i>	<i>Drawn by (3)</i>	<i>Ledger Folio (4)</i>	<i>Payee (5)</i>

<i>Date of the Bill (6)</i>	<i>Term (7)</i>	<i>Due Date (8)</i>	<i>Amount (9)</i>	<i>Disposal (10)</i>

13. CASH BOOK

Cash book may be defined as the record of transactions concerning cash receipts and cash payments. In other words in Cash Book, all transactions (i.e., receipts and payments of cash) are recorded as soon as they take place. Cash Book is in the form of an account and actually it

serves the purpose of Cash Account also. It has two sides - debit side and credit side. On the debit side, all receipts of cash are recorded while on the credit side, all the payments of cash are recorded. Items on the debit side of the Cash Book are posted on the credit side of the ledger accounts and items on the credit side are posted on the debit side of the ledger accounts. In case of cash transactions, only a single aspect of transactions is recorded in ledger because the other aspect has to be recorded in Cash Book. Cash Book thus serves the purpose of a book of original entry as well as that of a ledger account.

A cash book has the following features:

- (a) Only cash transactions are recorded in the cash book.
- (b) It performs the functions of both journal and ledger at the same time.
- (c) All cash receipts are recorded in the debit side and all cash payments are recorded in the credit side.
- (d) It records only one aspect of transaction i.e. cash.
- (e) All cash transactions are recorded chronologically in the cash book.

Types of Cash Book

The cash book can be of the following types:

(i) *Simple (Single Column) Cash Book* : It is like an ordinary cash account. In this all cash receipts are recorded on the left hand side (real account - debit what comes in) and all cash payments are recorded on the right hand side (real account - credit what goes out). A specimen is as under:

Dr.				Cr.			
<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Amount Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Amount Rs.</i>

(ii) *Two (Double) Columnar Cash Book* : Such a cash book has two columns on both sides; one is for cash and another is for discount. Cash column is meant for recording cash receipts and payments while discount column is meant for recording discount received and allowed. The discount column on the debit side represents the discount allowed while discount column on the credit side represents the discount received. A specimen of two-columnar cash book is as under:

Dr.		Cash Book		Cr.	
<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Discount Rs.</i>	<i>Amount Rs.</i>	
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>	<i>(5)</i>	

<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Discount</i> <i>Rs.</i>	<i>Amount</i> <i>Rs.</i>
(6)	(7)	(8)	(9)	(10)

It should be noted that the cash column of the cash book serves both the functions of a cash book as well as cash account but the discount columns do not serve the function of a discount account. Discount columns are merely memorandum columns. Discount allowed account and discount received account are opened in the ledger and the totals of discount columns are posted in these accounts.

(iii) *Three Columnar Cash Book* : This type of cash book contains the following three columns on each side:

- (a) Discount column for discount received and allowed;
- (b) Cash column for cash received and cash paid; and
- (c) Bank column for money deposited and money withdrawn from the bank.

The ruling of a three columnar cash book is as follows:

Cash Book					
<i>Dr.</i>					<i>Cr.</i>
<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Discount</i> <i>Rs.</i>	<i>Cash</i> <i>Rs.</i>	<i>Bank</i> <i>Rs.</i>
(1)	(2)	(3)	(4)	(5)	(6)

<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Discount</i> <i>Rs.</i>	<i>Cash</i> <i>Rs.</i>	<i>Bank</i> <i>Rs.</i>
(7)	(8)	(9)	(10)	(11)	(12)

When the introduction of bank column on both sides of the cash book there is no need for a separate bank account in the ledger. The bank account maintained by the enterprise is a personal account and the cash account is a real account. For recording transactions in the bank

column of the cash book the rule of debit and credit applicable to personal accounts should be followed i.e. debit the receiver and credit the giver.

Thus, when cash is deposited into bank, the bank would be the receiver and would be debited in the bank column of the cash book. Similarly, for cash withdrawn from the bank the bank would be the giver and would be credited in the bank column of the cash book. However, when cash is received it is recorded on the debit side in the cash column and whenever cash is paid out, it is entered on the credit side in the cash column.

One important feature of this cash book is that if a transaction involves, both cash and bank account, it is entered on both sides of the cash book, one in the cash column and second in the bank column, though on opposite sides. This is called contra entry and word 'C' is indicated against that item in L.F. column. e.g. when cash is withdrawn from the bank, it is recorded on the debit side in cash column and on the credit side in the bank column. Similarly, when cash is deposited with the bank, the amount is recorded on the debit side in bank column and on the credit side in the cash column.

(iv) *Cash Receipts and Payments Book or Journal* : In practice cash receipts and cash payments book may be employed respectively to record cash receipts and cash payments especially when the cash transactions are numerous.

The posting is usually done daily from these books to the ledger accounts. The total cash received as shown by the cash receipts journal is debited to cash account and the total cash paid as shown by the cash payment journal is credited to cash account at the end of a period.

Illustration 8

Record the following transactions in Cash Book of Mr. Singh:

2007		Rs.
April	1 Mohan Lal commenced business with cash	1,00,000
"	2 Bought goods for cash	65,700
"	3 Sold goods for cash	4,320
"	6 Received cash from Fateh Singh	1,800
"	6 Allowed him discount	50
"	9 Paid cash to Shugan Chand	19,500
	Discount allowed by Shugan Chand	500
"	12 Paid for Office Furniture	5,680
"	18 Sold goods for cash	7,810
"	23 Received cash from Subramaniam	9,870
"	Discount allowed to him	120
"	27 Paid for advertising	500
"	28 Cash paid to Asia Trading Co.	20,300
	Discount received	250
"	30 Cash sales	1,280
"	30 Cash received from Fateh Singh	2,850
	Discount allowed to him	100
	Salary paid in cash	3,150

Solution :

**Mr. Singh
Cash Book**

<i>Dr.</i>					<i>Cr.</i>				
<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Discount Rs.</i>	<i>Amount Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Discount Rs.</i>	<i>Amount Rs.</i>
2007					2007				
April 1	To Capital A/c	1		1,00,000	April 2	By Purchases A/c	2		65,700
" 3	" Sales A/c	3		4,320	" 9	" Shugan Chand	11	500	19,500
" 6	" Fateh Singh	7	50	1,800	" 12	" Furniture A/c	6		5,680
" 18	" Sales A/c	3		7,810	" 27	" Advertising A/c	24		500
" 23	" Subramaniam	14	120	9,870	" 28	" Asia Tr. Co.	26	250	20,300
" 30	" Sales A/c	3		1,280	" 30	" Salary A/c	31		3,150
" 30	" Fateh Singh	7	<u>100</u>	<u>2,850</u>	" 30	" Balance c/d			<u>13,100</u>
			<u>270</u>	<u>1,27,930</u>				<u>750</u>	<u>1,27,930</u>
May 1	To Balance b/d			13,100					

Illustration 9

On 1st May, 2007 the columnnar cash book of Mitra showed that he had Rs. 2,000 in his cash box and that there was a bank overdraft of Rs. 8,000. During the day the following transactions took place:

Cash withdrawn from bank for office use	10,000
Paid salaries in cash	3,000
Cash paid to Harish & Co.	6,500
Drawings in cash made by Mitra for household expenses	1,000
Received from G. Guha in settlement of an account of Rs. 10,000, Rs. 1,800 in cash and a cheque of Rs. 8,000. The cheque was immediately deposited in bank	
Cash sales	6,500
Bank returns a cheque of Rs. 9,900 received from Kulu & Sons in settlement of an account of Rs. 10,000	
Paid rent by cheque	1,500
Cash deposited with bank	6,000

Write up the Cash Book for the day and balance it.

Solution :

Cash Book

Dr.						Cr.					
Date	Parti- culars	L.F.	Dis- count Rs.	Cash Rs.	Bank Rs.	Date	Parti- culars	L.F.	Dis- count Rs.	Cash Rs.	Bank Rs.
2007						2007					
May 1	To Bal b/d			2,000		May 1	By Bal b/d				8,000
	To Bank (C)			10,000			By Cash A/c (C)				10,000
	To G.Guha	200	1,800		8,000		By Salaries A/c		3,000		
	To Sales A/c			6,500			By Harish & Co.			6,500	
	To Cash A/c (C)				6,000		By Drawing A/c			1,000	
	To Bal c/d				15,400		By Kulu & Sons	100			9,900
							By Rent A/c				1,500
							By Bank (C)		6,000		
							By Bal c/d			3,800	
									100	20,300	29,400
May 2	To Balance b/d			3,800		May 2	By Balance b/d				15,400

Note :

Discount is allowed even when the payment is received by means of a cheque. Such a discount is recorded in the Discount Column (as shown in the case of receipt of cash and cheque and cheque from G.Guha in the above illustration). If later on, the cheque is dishonored due to some reason, the amount of such a discount is written back by means of an entry in the Discount column on the credit side; of course, the amount of the cheque is also recorded on the credit side in Bank column (as has been shown in the case of dishonour of cheque received from Kulu & Sons in the above illustration).

Posting the entries in the cash book shown in the above illustration will appear as follows:

Salaries Account

Dr.				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007							
May 1	To Cash A/c		3,000				

Harish & Co.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007							
May 1	To Cash A/c		6,500				

Drawings Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007							
May	To Cash A/c		1,000				

G.Guha's Account

Dr.				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.

	2007				
May 1	By	Cash A/c	1,800		
		By Bank		8,000	
		By Discount A/c		200	

Sales Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2007			
	May 1			By	Cash A/c	6,500	

Kulu & Sons

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007							
May 1	To Bank		9,900				
	To Discount A/c		100				

Rent Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007							
May 1	To Cash		1,500				

In addition to the above mentioned entries, Discount Account will also be debited and credited with the total discount allowed and received at the end of the month. As the Cash Book has been prepared only for one day, this has not been shown.

Many people, while posting Cash Book, do not give details in the Ledger Accounts regarding amounts pertaining to cash, bank and discount; as they simply write 'To Cash Book' or 'By Cash Book' as the case may be. To give an example, the posting in the account of G.Guha will appear as follows if this method is adopted.

G.Guha's Account

Dr.				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2006			
	May 1			By Cash Book	10,000		

14. PETTY CASH BOOK

In every business, there is the need to make provision for a number of payments in cash of small amounts. Such payments may be regarded as sundry or petty expenses e.g. traveling expenses, postage, carriage etc. These petty cash expenses are recorded in the petty cash book which contains analysis columns with appropriate heading for the more usual classes of petty expenses. The petty cash book is maintained by separate cashier known as petty cashier. The petty cashier receives money from the main cashier periodically from which he meets all the petty expenses. This cash book is prepared in an analytical form for the accounting heads for which frequent payments are made. The total of all such heads, once in say, every month, will be posted to the ledger.

The petty cashier keeps the cash in the office and uses it to pay off only such expenses as he is authorised to do against a proper receipt or voucher for each item of payment. These receipts or vouchers provide not only the evidence of cash disbursements but also a control over the petty

cash fund and may be used as the basis for replenishing the cash. the balance in the petty cash book shows cash lying with the petty cashier. In big organisations petty cash book is maintained because of the following reasons:

- (a) In big business the number of petty payments is large.
- (b) These payments recur at regular intervals.
- (c) It is not usually possible to issue cheque in payment of any item.
- (d) The person receiving the payment may be an employee of the business.

Petty Cash Book may be treated either as a part of the double entry system or merely as a memoranda book. If the former course is adopted, each payment to petty cashier is shown on the credit side of the main Cash Book which is considered to have been balanced by a debit entry in the petty cash book. The two entries are folioed against each other completing the double entry aspects. Payments recorded in the Petty Cash Book are directly posted to the different nominal accounts. Of course, entries for expenses are made only with the periodical totals of expenses under various heads. If the latter course is adopted, for amounts paid to petty cashier, petty cash account in the ledger is debited besides entering the amounts (paid to petty cashier) on the credit side of the main cash book and recording the amount in the petty cash book. Periodically, different nominal accounts are debited and the petty cash account is credited in ledger for expenses recorded in Petty Cash Book.

The balance in the petty cash book account shows cash lying with the petty cashier.

15. IMPREST SYSTEM OF PETTY CASH

In every business of whatever size, there are many payments which are of small amounts and high frequency e.g. payments for postage, stationery, telegrams, carriage, cleaning, traveling etc. and these transactions are recorded in a separate book called petty cash book. This book is maintained by the petty cashier.

Under the imprest system of maintaining petty cash, the petty cashier is given a certain sum of money at the beginning of the fixed period (e.g. a month/fortnight) which is called float. The amount of float is so fixed that it may be adequate to meet petty expenses of the prescribed period. The petty cashier makes payment of petty expenses for which he is authorised and records them in his cash book. At the end of such period, the petty cashier submits the account of the amount spent by him during the period, and the cashier gives him cash equal to the spent amount so that the petty cashier begins the next period with the fixed amount of float.

The advantages of the imprest system are as follows:

- (i) It saves the time of the chief cashier.
- (ii) Petty cashier is not allowed to keep idle cash with him if the float is found to be more than adequate; its amount will be immediately reduced. This reduces the chances of misuse of cash by the petty cashier.
- (iii) As the sum of float is small, it does not provoke the person in charge of it or others in the office to misappropriate it.
- (iv) The record of petty cash is checked by the cashier, periodically, so that a mistake if committed is soon rectified.
- (v) It enables a great saving to be effected in the posting of small items to the ledger accounts.
- (vi) The system trains young staff to handle money responsibilities.

Illustration 10

Prepare an analytical Petty Cash Book from the following information:

Petty cash is maintained on the basis of imprest system. On 20th March, 2007 the petty

cashier had with him Rs. 328. He received Rs. 672 to make up the expenses of the previous week. During the week the following expenses were met by the petty cashier:

2007		Rs.
March 20	Bus fare	6
" 21	Revenue stamps	85
	Tea for customers	22
" 22	Cartage	43
" 24	Cooli	10
	Telegram charges	76
	Refreshment for customer	52
" 25	Repairs to furniture	100
	Taxi charges	87
	Post cards	90
	Cloth for dusters	74
	Tea for customers	20

Solution :

Analytical Petty Cash Book

Amount Recd.	Date	Particulars	VR No.	Amount Paid	Cartage & Cooli	P & T	Conve- yance	Custo- mers Enter- tainment	Sun- dries
1	2	3	4	5	6	7	8	9	10
Rs.	2007			Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
328	Mar. 20	To Bal. b/d							
672	" "	To Cash A/c							
	" "	By Bus Fare		6			6		
	" 21	By Rev. Stamps		85		85			
	" "	By Tea for Customers		22				22	
	" 22	By Cartage		43	43				
	" 24	By Cooli		10	10				
	" "	By Telegram charges		76		76			
	" "	By Refreshment to customers		52				52	
	" 25	By Repairs to Furniture		100					100
	" "	By Taxi Charges		87			87		(Rep.
	" "	By Post Cards		90		90			(to fur-
	" "	By Cloth for Dusters		74					niture)
	" "	By Tea for Customers		20				20	74
									Gen.
									Exp.
				<u>665</u>	<u>53</u>	<u>251</u>	<u>93</u>	<u>94</u>	<u>174</u>
		By Balance c/d		<u>335</u>					

<u>1,000</u>				<u>1000</u>
335	"	27	To	Balance b/d
665	"	"	To	Cash A/c

The journal entry required for various petty cash expenses are the following:

		Rs.	Rs.
Cartage A/c	Dr.	53	
Postage and Telegrams A/c	Dr.	251	
Conveyance A/c	Dr.	93	
Customer's Entertainment A/c	Dr.	94	
Repairs A/c	Dr.	100	
General Expenses A/c	Dr.	74	
To Petty Cash Account			665

The Petty Cash Account in the ledger will appear as follows:

Petty Cash Account							
Dr.				Cr.			
2007			2007				
Mar. 20	To	Balance b/d	328	Mar. 26	By	Sundries*	665
"	To	Cash A/c	<u>672</u>	"	By	Balance c/d	<u>335</u>
			<u>1,000</u>				<u>1,000</u>
Mar. 27	To	Balance b/d	335				
"	To	Cash	665				

*Of course, individual accounts concerned may be stated.

Illustration 11

Raju started business on 1st January 2007. You are required to prepare his books of account for January 2007. His transactions for the month were follows:

2007		Rs.
Jan. 1	Cash brought in by Raju as his capital	2,00,000
	Furniture purchased on credit from Nuluk Furniture Home	25,000
" 2	Goods purchased from Modi & Sons on credit	61,400
" 3	Goods purchased for cash	35,000
4	Goods purchased from Delhi Traders on credit	73,300
" 5	Cash Sales	4,600
" 8	Sold goods to Bhatia & Co. on credit	19,860
11	Purchased stationery for cash	1,050
" 12	Paid Modi & Sons cash to settle account	
	Received 5% discount from him	
" 13	Received from Bhatia & Co. in full settlement of account	19,800
" 17	Cash sales	10,700
" 18	Sold on credit to Ganesh & Co.	5,000

"	19	Received cash from Ganesh & Co.	1,000
"	21	Sold on credit to Hoshiar Singh	4,000
"	23	Purchased goods for cash	26,000
"	27	Hoshiar Singh becomes insolvent. A first and final dividend of Rs. 3,000 is received from his estate	
"	31	Ganesh & Co. pays cash	3,900
"	31	Discount allowed to Ganesh & Co.	100
"	31	Cash paid for rent	2,800
"	31	Depreciation on furniture	250
"	31	Payment to Delhi Traders in full settlement	73,000

Solution:

Journal

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr. Rs.</i>	<i>Cr. Rs.</i>
2007				
Jan. 1	Furniture Account	Dr.	25,000	
	To Nuluk Furniture Home			25,000
	(For furniture purchased on credit from Nuluk Furniture Home)			
" 27	Bad Debts	Dr.	1,000	
	To Hoshiar Singh			1,000
	(Bad debts written off on the insolvency of Hoshiar Singh)			
" 31	Depreciation A/c	Dr.	250	
	To Furniture A/c			250
	(For depreciation provided on Furniture)			
	Total		<u>26,250</u>	<u>26,250</u>

Purchases Book Month : January, 2007

<i>Date</i>	<i>Particulars</i>	<i>Invoice No.</i>	<i>L.F.</i>	<i>Details</i>	<i>Amount Rs.</i>
2007					
Jan. 2	Modi & Sons Goods				61,400
Jan. 4	Delhi Traders Goods				<u>73,300</u>
	Totals				<u>1,34,700</u>

Sales Book Month : January, 2007

<i>Date</i>	<i>Particulars</i>	<i>Invoice No.</i>	<i>L.F.</i>	<i>Details</i>	<i>Amount Rs.</i>
2007					
Jan. 8	Bhatia & Co.				19,860
" 18	Ganesh & Co.				5,000
" 21	Hoshiar Singh				<u>4,000</u>
					<u>28,860</u>

Dr.	Cr.
-----	-----

Cr.

Feb. 1	To Balance b/d	46,820
--------	----------------	--------

Dr. _____ *Cr.* _____

Cr.

Feb. 1	"	Balance b/d	2,00,000
--------	---	-------------	----------

Feb. 1	To	Balance b/d	24,750
--------	----	-------------	--------

Jan. 31	To Balance c/d	<u>25,000</u>	Jan. 31	By Furniture	<u>25,000</u>
			Feb. 1	" Balance b/d	25,000

	61,400	61,400
--	--------	--------

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 3	To Cash A/c		35,000	Jan. 31	By Balance c/d		1,95,700
" 23	" Cash A/c		26,000				
" 31	" Sundries as per Purchases Book		<u>1,34,700</u>				
			<u>1,95,700</u>				<u>1,95,700</u>
Feb. 1	" Balance b/d		1,95,700				

Delhi Traders

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 31	To Cash A/c		73,000	Jan. 4	By Purchases		73,300
"	" Discount A/c		<u>300</u>				
			<u>73,300</u>				<u>73,300</u>

Dr. Sales Account				Cr.			
Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 31	To Balance c/d		44,160	Jan. 5	By Cash A/c		4,600
				Jan. 17	" Cash A/c		10,700
				Jan. 31	" Sundries as per Sales Account		<u>28,860</u>
			<u>44,160</u>				<u>44,160</u>
				Feb. 1	By Balance b/d		44,160

Bhatia & Co.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 8	To Sales A/c		19,860	Jan. 13	By Cash A/c		19,800
				"	" Discount A/c		<u>60</u>
			<u>19,860</u>				<u>19,860</u>

Stationery Account

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 11	To Cash A/c		<u>1,050</u>	Jan. 31	By Balance c/d		<u>1,050</u>
Feb. 1	To Balance b/d		1,050				

Genesh & Co.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2007				2007			
Jan. 18	To Sales A/c		5,000	Jan. 19	By Cash A/c		1,000
				" 31	" Cash A/c		3,900
				"	" Discount A/c		<u>100</u>

5,000

5,000

Hoshiar Singh									
Date	Particulars		J.F.	Rs.	Date	Particulars		J.F.	Rs.
2007					2007				
Jan. 21	To	Sales A/c		4,000	Jan. 27	By	Cash A/c		3,000
							"	Bad Debts A/c	<u>1,000</u>
				<u>4,000</u>					<u>4,000</u>

Bad Debts Account									
Date	Particulars		J.F.	Rs.	Date	Particulars		J.F.	Rs.
2007					2007				
Jan. 27	To	Hoshiar Singh		<u>1,000</u>	Jan. 31	By	Balance c/d		1,000
Feb. 1	"	Balance b/d		1,000					

Rent Account									
Date	Particulars		J.F.	Rs.	Date	Particulars		J.F.	Rs.
2007					2007				
Jan. 31	To	Cash A/c		<u>2,800</u>	Jan. 31	By	Balance c/d		<u>2,800</u>
Feb. 1	"	Balance b/d		2,800					

Depreciation Account									
Date	Particulars		J.F.	Rs.	Date	Particulars		J.F.	Rs.
2007					2007				
Jan. 31	To	Furniture		<u>250</u>	Jan. 31	By	Balance c/d		250
Feb. 1	"	Balance b/d		250					

Discount Account									
Date	Particulars		J.F.	Rs.	Date	Particulars		J.F.	Rs.
2007					2007				
Jan. 31	To	Sundries for Discount Allowed as per debit side of Cash Book		160	Jan. 31	By	Sundries for Discount Received as per credit side of Cash Book		3,370
" 31	"	Balance b/d		<u>3,210</u>					<u>3,370</u>
				<u>3,370</u>					

16. GENERAL JOURNAL

This is also known as Journal Proper. It is used for making the original record of such transactions for which no special journal has been kept in the business. Entries recorded in the general journal may be confined to the following transactions:

- (i) *Opening Entries* : Opening entries are used at the beginning of the financial year to open

the books by recording the assets, liabilities and capital appearing in the balance sheet of the previous year. It is written as follows:

Assets Account Dr.
 To Liabilities Account
 To Capital Account

(ii) *Closing Entries* : Closing entries are used at the end of the accounting year for closing off accounts relating to expenses and revenues. These accounts are closed by transferring their balances to the Trading, Profit and Loss Account.

(iii) *Adjustment Entries* : At the end of the accounting year, adjustments entries are to be passed for outstanding/prepaid expenses, accrued income/income received in advance etc. Entries for all these adjustments are passed in the general journal.

(iv) *Transfer Entries* : Transfer entries are passed in the general journal for transferring an item entered in one account to another account.

(v) *Rectification Entries* : Rectification entries are passed for rectifying errors which might have committed in the books of account.

(vi) *Purchase of Fixed Assets/Stationery* : When fixed assets or stationeries are purchased on credit, the entries are passed in the general journal.

(vii) *Sale of Worn-out or Obsolete Assets* : When obsolete assets are sold on credit, these are originally recorded in the general journal.

Illustration 12

On 31st March, 2007 following balances are available in ledger for the year 2006 - 07.

	Rs.
Furniture (debit balance)	20,000
Stock of Goods Account (debit balance)	70,000
S. Sircar (debit balance)	14,000
M. Mitra (debit balance)	7,500
Cash (debit balance)	2,400
B. Basu (credit balance)	13,900
Capital Account (credit balance)	1,00,000

Write the opening entry for 1st April, 2007.

Solution :

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
2007			Rs.	Rs.
April 1	Furniture A/c	Dr.	20,000	
	Stock of Goods	Dr.	70,000	
	S.Sircar	Dr.	14,000	
	M. Mitra	Dr.	7,500	
	Cash A/c	Dr.	2,400	
	To B. Basu			13,900
	To Capital Account			1,00,000
	(For opening balances of various assets,			

liabilities and capital as on 1st April, 2007)

The entry will be posted in ledger as follows:

Furniture Account

<i>Dr.</i>				<i>Cr.</i>			
<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>
2007							
April 1	To Balance b/d		20,000				

Stock of Goods Account

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>
2007							
April 1	To Balance b/d		70,000				

S. Sircar

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>
2007							
April 1	To Balance b/d		14,000				

M. Mitra

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>
2007							
April 1	To balance b/d		7,500				

Cash Book

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>
2007							
April 1	To Balance b/d		2,400				

B. Basu

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>
2007							
April 1	By Balance b/d		13,900				

Capital Account

<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Rs.</i>
2007							
April 1	By Balance b/d		1,00,000				

17. TRIAL BALANCE

Under double entry system, for every transaction, one account is debited and some other account is credited with the amount of the transaction. Obviously, if before balancing the amounts on the debit side of all accounts (including cash book which is also cash account) are totalled, such grand total must be equal to the grand total of the amounts on the credit side of all the accounts (including cash book). If the two sides differ, it is a signal that there has been some mistake.

You know that if equals are subtracted from equals, the remainders will also be equal. Hence, instead of taking the total amounts of the debit sides and credit sides of all accounts (before balancing them) only the balance of the accounts can be taken.

A trial balance is a schedule or list of balances both debit and credit extracted from various accounts in the ledger including cash and bank balances from cash book. Since every transaction has a dual effect i.e. every debit has a corresponding credit and vice versa, the total of the debit balances and credit balances extracted from the ledger must tally. Thus, at the end of the accounting period or at the end of each month, the balances of the ledger accounts are extracted and a schedule of debit and credit balances is prepared to test as to whether the total debits are equal to total credits. Such a schedule is referred to as trial balance. The following are the main features of a trial balance:

- (i) It is a statement prepared in a tabular form. It has two columns one for debit balances and another for credit balances.
- (ii) The balances at the end of the period as shown by ledger accounts are shown in the statement.
- (iii) It can be prepared on any date provided accounts are balanced.
- (iv) It is a method of verifying the arithmetical accuracy of entries made in the ledger.

The preparation of a trial balance has the following objectives:

- (i) It is a check on the accuracy of posting. If the trial balance agrees it proves that:
 - (a) the books are arithmetically accurate, and
 - (b) both the aspects of the transactions have been correctly recorded in the books of original entry as well as in the ledger.
- (ii) It brings together the balances of all the accounts at one place and this facilitates the preparation of profit and loss account and balance sheet.

There are mainly two methods of preparing the trial balance:

- (i) *Totals method* : In this method, the totals of debit and credit sides of the ledger accounts are shown in the trial balance. The sum totals of debit and credit columns of the trial balance must be equal. But this is not a popular method.
- (ii) *Balances method* : In this method, the balances of ledger accounts are taken to respective debit and credit columns of the trial balance and then grand total is taken out. The total of balances in the debit column must be equal to the total balances in the credit column of the trial balance.

Consider the ledger accounts shown in the illustration 11 above, if a trial balance is extracted on the basis of those ledger accounts, it would appear as follows:

Raju's Trial Balance
(With totals)
as on 31st January, 2007

<i>Name of the Accounts</i>	<i>Debit Totals</i>	<i>Credit Totals</i>

(1)	(2)	(3)
	<i>Rs.</i>	<i>Rs.</i>
1. Cash	2,43,000	1,96,180
2. Capital Account		2,00,000
3. Furniture Account	25,000	250
4. Nuluk Furniture Home		25,000
5. Modi & Sons	61,400	61,400
6. Purchase Account	1,95,700	
7. Delhi Traders	73,300	73,300
8. Sales Account		44,160
9. Bhatia & Co.	19,860	19,860
10. Stationery Account	1,050	
11. Ganesh & Co.	5,000	5,000
12. Hoshiar Singh	4,000	4,000
13. Bad Debts Account	1,000	
14. Rent Account	2,800	
15. Depreciation Account	250	
16. Discount Account	160	3,370
	<u>6,32,520</u>	<u>6,32,520</u>

Raju's Trial Balance
(With net Balance)
as on 31st January, 2007

<i>Name of the Accounts</i>	<i>Debit Balances</i>	<i>Credit Balances</i>
	<i>Rs.</i>	<i>Rs.</i>
1. Cash		46,820
2. Capital Account		2,00,000
3. Furniture Account	24,750	
4. Nuluk Furniture Home		25,000
5. Purchases Account	1,95,700	
6. Sales Account		44,160
7. Stationery Account	1,050	
8. Bad Debts Account	1,000	
9. Rent Account	2,800	
10. Depreciation Account	250	
11. Discount Account		3,210
	<u>2,72,370</u>	<u>2,72,370</u>

SELF-TEST QUESTIONS

1. Indicate the subsidiary book in which following transactions will be recorded in each case:

- (a) Credit sales of goods in trade.
- (b) Credit purchase of furniture in office
- (c) Payment of salary in cash
- (d) Cash sales
- (e) Receipt of a cheque from a customer
- (f) Return of goods by a customer to whom money is refunded immediately
- (g) Bad debts
- (h) Deposit of cash with bank
- (i) Drawings of goods by proprietor for domestic use, the goods being invoiced at selling price
- (j) Amount of rent due to landlord at the end of the financial year
- (k) Credit purchase of goods in trade.

[Ans. : Journal - (b), (f), (g), (i), (j)
Purchases Book - (k)
Cash Book - (c), (d), (e), (f) and (h)
Sales Book - (a)]

2. State which of the following statements are incorrect:

- (i) When three column-cash book is maintained, no bank account appears in the ledger.
- (ii) Only those transactions which do not find place in any other subsidiary books are recorded in journal.
- (iii) Contra items in columnar cash book require no posting in the ledger.
- (iv) In sales book, only credit sales of goods in trade are recorded.
- (v) Cash book is a subsidiary book as well as a part of the main book (i.e. Ledger).
- (vi) Discount columns in the cash book do not serve the purpose of Discount Account; a Discount Account has to be prepared in ledger.
- (vii) Cash discount is allowed to encourage early payment.

[All statements are correct.]

3. Distinguish between journal and ledger.

4. What do you mean by contra-entries in a columnar cash book?

5. What is meant by columnar cash book?

6. What is meant by analytical petty cash book?

7. Describe the imprest system.

8. Journalise the following transactions:

	2007		Rs.
(i)	Jan. 1	Bought office furniture from Kanji & Co.	6,000
(ii)	" 5	Bought goods from F. Roy	5,000
(iii)	" 10	Bought goods from P. Gupta	10,000
(iv)	Feb. 1	Sold goods to K. Peter	4,000
(v)	" 5	Sold goods to P. Turpin & Co.	7,000
(vi)	" 12	Bought goods from C. Henry	4,500
(vii)	" 17	Bought goods from J. Jones	2,000
(viii)	" 20	Sold goods to S. Sorab & Co.	18,000
(ix)	" 23	Sold goods to B. Byramji	1,750

(x)	"	25	Received cash from P. Turpin & Co.	3,000
(xi)	"	27	Received cash from K. Peter	2,500
(xii)	"	28	Paid cash to F. Roy	1,000
(xiii)	"	28	Paid cash to P. Gupta	5,000
(xiv)	Mar.	4	Paid salaries	2,000
(xv)	"	5	Paid office rent	750
(xvi)	"	7	Sold goods for cash	2,750
(xvii)	"	8	Bought goods for cash	1,250
(xviii)	"	11	Paid for stationery	250
(xix)	"	15	Received cash from S. Sorab & Co.	14,750
(xx)	"	15	Received cash from B. Byramji	1,750
(xxi)	"	17	Paid cash to C. Henry	3,500
(xxii)	"	17	Paid cash to J. Jones	2,000
(xxiii)	"	20	Purchased goods for cash	1,000
(xxiv)	"	25	Paid Kanji & Co.	6,000

9. Rolly Polly was carrying on business as a cloth dealer. His transactions during April, 2007 were as follows:

2007				Rs.
Apr.,	1	Sold cloth on credit to Gifloo		5,000
"	2	Purchased cloth from Amboo on credit		20,000
"	3	Paid rent for April by cheque		3,000
"	4	Cash purchases of cloth (paid by cheque)		8,000
		Cash sales		4,500
"	6	Paid for stationery and postage		500
"	8	Drawn cash for private use		2,500
"	10	Drawn cash from Bank for office		15,000
"	13	Purchased goods on credit from Minoo		25,000
"	16	Sold goods on credit to Gopal		18,000
"	17	Paid telephone charges		4,800
"	18	Cash sales		3,000
		Paid for advertising		3,500
"	22	Cash purchases		9,000
"	24	Purchased filing cabinet and paid by cheque		5,000
"	27	Purchased Government securities		30,000
		Paid wages for the month		8,000

Journalise the transactions.

10. Enter the following transactions in a cash book, with cash, bank and discount columns and bring down the balances:

March, 2007				Rs.
"	1	Balance at bank		20,000
		Purchased goods by cheque		10,000
		Drew cheque for office cash		500
		Purchased stationery for cash		100
"	8	Received from C-cheque		1,250
		Allowed discount		30
"	9	Received from A-cheque		1,400
		Allowed discount		40
"	10	Carriage paid in cash		30

"	12	Received cheque from D	1,750
		Allowed discount	30
"	13	Paid for cooly hired-cash	80
		Drew cheque favoring G for rent	1,800
"	15	Paid for purchases-cheque	20,000
		Received from C-cheque	900
		Allowed discount	20
"	20	Paid for postage-cash	50
		Paid K by cheque	1,950
		Discount allowed by him	50
"	22	Received cheque for sales	1,500
"	25	Paid for cleaning office	50
"	27	Paid wages-cash	500
	30	Drew cheque for electricity	2,000
		Drew cheque for office use	3,000

(Ans.: Cash in hand Rs. 2,690; Bank overdraft Rs. 12,450; Discount - Dr. Rs. 120 and Cr. Rs. 50).

11. X operates two Bank Accounts both of which are maintained in the columnar cash book itself. You are required to draw up a Pro forma of the Cash Book and show how the following transactions relating to 28th February, 2007 will appear therein and close the cash book for the day.

1. Opening balances:

	<i>Rs.</i>	
Cash	1,500	
National Bank	1,12,400	(overdraft)
Overseas Bank	3,54,600	

- Received cheque for Rs. 12,500 in respect of sales for realising which the National Bank charged Rs. 20 and credited the balance.
- Purchased goods for Rs. 1,32,100 and a cheque issued on the Overseas Bank. The Bank charged Rs. 30 for collection of the cheque to the concerned party.
- Paid office expenses: Rs. 450 and Rs. 150 for stationery.
- Out of cash sales of Rs. 1,32,650 a sum of Rs. 1,00,000 was deposited in the National Bank.
- Credit purchases of Rs. 1,50,000 were made from Smith, who sent the documents relating to goods through the Overseas Bank for 90 per cent of their value. The bank charged Rs. 1,150 for releasing the document.
- Deposited Rs. 50,000 in National Bank.
- A "Bill Receivable" for Rs. 1,00,000 was discounted with the Overseas Bank, which charges 1 per cent towards discounting.
- Withdrew Rs. 50,000 from the Overseas Bank.
- A Demand Draft was purchased for Rs. 30,000 from a bank after paying Rs. 20 towards their charges and paid to the Electricity Department as deposit.
- Interest of Rs. 1,220 and Rs. 500 was credited and debited respectively by the Overseas Bank and National Bank.
- An amount of Rs. 15,000 was withdrawn from the Overseas Bank and salaries paid to that extent.

13. Manager's salary of Rs. 10,000 was paid by cheque drawn on the National Bank.
14. Overseas Bank collected dividends of Rs. 12,500 and sent a credit note.
15. An amount of Rs. 15,000 was transferred from the Overseas Bank to the National Bank.

(Ans.: Balance — Cash Rs. 3,530; National Bank Rs. 54,580; Overseas Bank Rs. 1,19,070.)

Suggested Readings :

- (1) *M.C. Shukla, T.S. Grewal and S.C. Gupta* — Advanced Accounts, Vol. I
 - (2) *J.R. Monga* — Advanced Financial Accounting
 - (3) *R.L. Gupta and V.K. Gupta* — Financial Accounting
 - (4) *S.N. Maheshwari* — Financial Accounting
 - (5) *S.P. Jain and K.L. Narang* — Financial Accounting
-

STUDY III

BANK RECONCILIATION STATEMENT

1. INTRODUCTION

A bank is an institution which deals in money. Its main business is to accept deposits and to lend money. It also collects money and makes payments on behalf of its clients. Bank account is a personal account and the account holders record their transaction with the bank in a similar manner as they do with any other person.

Money can be deposited with a bank in three types of accounts. These are (i) Current Account, (ii) Savings Bank Account, (iii) Fixed Deposit Account.

(i) In a Current Account, money can be deposited as often as desired and also, it can be withdrawn without notice as often as necessary. In this account, with the permission of the bank, the amount withdrawn can be in excess of the amount deposited; the excess amount withdrawn is called overdraft. Generally no interest is allowed by banks on deposits in current accounts. On the other hand, a charge is made by the bank, known as bank charges, in every six months or every year. The client can instruct one bank to collect money, say interest or dividends on investments made by the client and to make payments say premiums of insurance policy on his behalf. The bank credits the client's account with such collections made and debits the client's account with such payments. It charges money for such services; the amount of the charge is debited by the bank to the client's account. Businessmen invariably prefer the current account to other two account as this account alone meets all their requirements.

(ii) In a Savings Bank Account, deposits can be made as often as required but there are restrictions on the number as well as amount of withdrawals that can be made and hence a savings bank account fails to meet the requirements of most of the businessmen. But this

account has the advantage that bank allows interest on the deposits made in it. This account is really meant for individuals who wish to save or institutions which do not need withdrawals very often.

(iii) In a Fixed Deposit, money is deposited only and cannot be withdrawn before the expiry of that period for which it is made. The bank pays interest on such a deposits. Fixed deposit is evidenced by a receipt called Fixed Deposits Receipt issued by the bank in the name of the depositor. The receipt has to be surrendered to the bank on the expiry on the stipulated date for withdrawal of money deposited and interest allowed thereon by the bank.

2. DEPOSITS AND WITHDRAWALS

In savings accounts and current accounts, a deposit is made by filling up a form called pay-in-slip. There is a counterfoil which is stamped by the bank's cashier and signed by him and returned to the client. This counter-foil is an evidence that money has been duly received by the bank. Separate pay-in-slips have to be filled in for depositing cash and cheques. Also cheques which have local bank have to be filled in one pay-in-slip and cheques of out-station banks in another slip.

Withdrawals are made by means of cheques. A cheque is an unconditional order on the bank made by the client instructing the bank to pay a certain sum of money to the person named in the cheque or his order or the bearer. In the case of a saving bank account withdrawals may be allowed by filling in withdrawals form supplied by the bank rather than cheques.

The money deposited with bank is debited to bank account while money withdrawn from the bank is credited to bank account. The record of money deposited and withdrawn from the bank is maintained by the business its cash book with bank columns which can be balanced on any date and the balance so arrived is known as bank balance as per cash book.

3. BANK PASS BOOK

The bank on its part maintains in its ledger the account of its customers. Pass book is a copy of the clients accounts in the bank's ledger. Bank issues it to its clients. It is the duty of the client to send it to bank at intervals so that transactions can be recorded up-to-date. Pass book shows the transactions already entered into by the bank and the client (like cheques and cash deposited, amounts withdrawn, cheques paid by the bank, collections and payments made by the bank on behalf of the client) and the balance or overdraft shown by the client's account at the bank. The money deposited by the customer is credited to his account and the money withdrawn from the bank is debited to his account. The balance as per bank ledger indicated in the bank pass book is called the bank balance as per pass book.

4. BANK RECONCILIATION STATEMENT

The bank pass book and bank columns of the cash book record the same transactions; of course in the pass book the transactions are recorded from the point of view of the bank whereas in cash book they are recorded from the point of view of the client. The bank balance as per pass book can therefore, be expected to be equal to the bank balance as revealed by the cash book. However, in actual practice the two balances rarely agree because of the time lag of a few days between the entries made by the firm in cash book and by the bank in the pass book. Thus a comparison is necessary to find out the items on account of which differences have arisen and a need to reconcile the two balances. Thus a bank reconciliation statement is a statement which is prepared as on a particular date to reconcile the bank balance as per cash book with balance as per pass book by showing all causes of difference between the two.

5. CAUSES OF DIFFERENCE BETWEEN BANK BALANCE SHOWN BY CASH BOOK AND PASS BOOK

The following are the reasons for the difference between the balance shown by the cash book and the pass book.

(i) Cheques issued but not presented for payment :

When a cheque is drawn or issued in favour of a third party, it is immediately recorded in the cash book by debiting the party and crediting the bank and this has the effect of reducing the bank balance in the cash book. But the bank will not debit client's account until those cheques are presented for payment, and honoured. So long as it is not presented, the balance shown in the pass book is more than the balance shown by the cash book.

(ii) Cheques deposited for collection but not yet collected :

The client debits bank column of cash book as soon as he deposits cheques with the bank for collection, but the bank credits client's account only when it has collected cash on the cheque so deposited. It results in bank balance as per cash book higher than the balance as per pass book.

(iii) Bank charges not entered in the cash book :

The bank charges some amount from each customer by way of incidental charge, collection charges, etc. and debit his account for this reason from time to time. As soon as these charges

are made the bank debit the customer's account in its own book and this reduces the bank balance. But the customer will know such charges only when he receives a statement of account from the bank, until then, bank balance as per pass book will be less than bank balance as per cash book.

(iv) Interest credited or debited by bank not entered in the cash book :

When bank allows interest to a customer for deposits, it will credit customer's account and his bank balance will increase. But the customer is not making the entry in cash book simultaneously till he knows the fact, thus the balances differ. Likewise interest on overdraft is debited to the customers' account and till the same is not entered in the cash book resulted in difference in the balances.

(v) Direct collections on behalf of customers :

A banker may receive amounts due to the customer by way of dividends, rent, interests etc. directly from the persons concerned on account of standing instructions of the customer to such persons. Similarly, debtors also deposit the amount directly to the bank. The bank credits the account of the customer for such collections as soon as it gets such payments. But same will be entered in cash book only when customer receives the statement from the bank. Thus the balances differ.

(vi) Direct payment by bank :

Usually banks are given standing instructions for certain payments to be made, such as payment for insurance premium, interest on loan, electricity bill etc. Bank, while making payments, debits pass book but the customer has no information of the same till it is informed.

(vii) Dishonour of cheques/bills :

When cheque or bill of exchange discounted with the bank is dishonoured, the same is debited in the pass book but not given effect in the cash book until the intimation is received.

(viii) Cheques received and entered in the cash book but omitted to be deposited into the bank.

(ix) Errors :

There may be errors in the accounts maintained by the customer as well as by the bank. A wrong debit or credit given by the customer or the bank leads to the difference in the balances.

6. SIGNIFICANCE OF BANK RECONCILIATION STATEMENT

- (i) It highlights the causes of difference between the bank balance as per cash book and the balance as per pass book. Necessary corrections can therefore be carried out at an early date.
- (ii) It reduces the chance of fraud by the staff dealing in cash.
- (iii) It is moral check on the staff of the organisation to keep the cash records always up to date.
- (iv) Bank balance as per cash book can not be accepted as final unless it is supported by statement of passbook. When these two balances do not tally, a reconciliation becomes essential to determine the correct bank balance that can be used while finalising the accounts.
- (v) It helps in finding out actual position of the bank balance.

7. PREPARATION OF BANK RECONCILIATION STATEMENT

Periodically, a comparison is necessary to find out the items on account of which differences

have arisen and a need to reconcile the two balances. Thus, a bank reconciliation statement is prepared as on a particular date to reconcile the bank balance as per cash book with balances as per pass book by showing all causes of difference between the two. The statement starts with bank balance as per cash book and then additions to and subtraction from this balance are made to arrive at the balance of the pass book. Alternate procedure is to start with bank balance as per pass book and to end up with bank balance as per cash book.

The bank reconciliation statement is prepared on a particular date for a period. The following steps should be taken for preparing a bank reconciliation statement:

- (i) The cash book should be completed and the balance as per bank column on a particular date should be found out covering the period for which the statement has to be prepared.
- (ii) The bank should be requested to complete and send to the firm the bank pass book upto the date mentioned.
- (iii) Check the entries of the debit and credit sides of the bank columns of the cash book with corresponding entries in the credit and debit sides of the pass book relating to the same period.
- (iv) The unchecked items should be classified into common groups according to their characteristics.
- (v) The balance as shown by any one book (i.e. the cash book or the bank pass book) should be taken as the base. This is, as a matter of fact, the starting point for determining the balance as shown by the other book after making suitable adjustments taking into account the causes of difference.
- (vi) The effect of the particular cause of difference on the balance shown by the other book should be studied.
- (vii) In case the cause has resulted in an increase in the balance shown by the other book, the amount of such increase should be added to the balance as per the former book which has been taken as the base.
- (viii) In case, the cause has resulted in decrease in balance shown by the other book, the amount of such decrease should be deducted from the balance as per the former book which has been taken as the base.

The following proforma is useful for preparing the Bank Reconciliation Statement:

Bank Reconciliation Statement as on....

<i>Particulars</i>	<i>Rs.</i>	<i>Rs.</i>
Balance as per Cash Book		-
<i>Add :</i> (i) Cheques issued but not yet presented for payment	-	
(ii) Interest allowed by the bank	-	
(iii) Direct payment by customers into bank	-	
(iv) Interest on investment received by the bank	-	
(v) Dividend on shares collected by the bank	-	
(vi) Rebate on bills retired under rebate through the bank but full amount entered in the cash book	-	
(vii) Any wrong entry on Cr. side of the pass book	-	-
<i>Less :</i> (i) Cheques deposited into bank but not yet collected	-	
(ii) Bank charges	-	

(iii) Insurance premium paid by the bank	-	
(iv) Interest on overdraft charged by the bank	-	
(v) Dishonoured cheques / bills	-	
(vi) Drawings made but not entered in cash book	-	
(vii) Cheques received entered in the cash book but not deposited		
(viii) Any wrong entry on Dr. side of the pass book	-	-
Balance as per Pass Book		-

If the reconciliation statement has been started with balance, as per the pass book and to arrive at balance as per cash book the entries made above should be reversed i.e. all added items should be deducted and deducted items should be added.

The above said procedure may be summarized as under:

<i>Transactions</i>	<i>Starting with the Bank Balance as per Pass Book</i>	<i>Starting with the Bank Balance as per Cash Book</i>
(i) Cheques issued but not presented	<i>Deduct</i> : The amount of unpresented cheques.	<i>Add</i> : The amount of unpresented cheques.
(ii) Cheques deposited but not yet collected	<i>Add</i> : The amount of cheques deposited	<i>Deduct</i> : The amount of cheques deposited
(iii) Cheques received entered in the bank column of the cash book but not deposited	<i>Add</i> : The amount of cheques.	<i>Deduct</i> : The amount of cheques.
(iv) Dishonoured of cheques deposited earlier	<i>Add</i> : The amount of dishonoured cheques	<i>Deduct</i> : The amount of dishonoured cheques
(v) Collection of interest and dividends and interest allowed by the banker	<i>Deduct</i> : The amount of these items	<i>Add</i> : The amount of these items.
(vi) Bank charges	<i>Add</i> : The amount of bank charges	<i>Deduct</i> : The amount of bank charges.
Balance	Bank Balance as per Cash Book	Bank Balance as per Pass Book

In case the books show an adverse balance i.e. an overdraft, the procedure is just the reverse of that which has been discussed in the case of a favourable balance. Overdraft means overdrawing of a bank account. The customer is allowed to draw from his account over and above his balance subject to a limit agreed upon. For overdraft facility the banker will charge interest. In the case of overdraft, the bank pass book will show debit balance in the account of the customer and similarly there will be a credit balance in the bank column of the cash book. The following performa may be useful for preparing a Bank Reconciliation Statement in case of an overdraft.

Bank Reconciliation Statement as on....

<i>Particulars</i>	<i>Rs.</i>	<i>Rs.</i>
Overdraft as per Cash Book		—
<i>Add :</i> (i) Cheques deposited into bank but not yet collected	—	
(ii) Bank charges	—	
(iii) Insurance premium paid by the bank	—	
(iv) Interest on overdraft charged by the bank	—	
(v) Dishonoured cheques/bills	—	
(vi) Drawings made but not entered in cash book	—	
<i>Particulars</i>	<i>Rs.</i>	<i>Rs.</i>
(vii) Cheques received entered in the cash book but not deposited		
(viii) Any wrong entry on Dr. side of the pass book	—	—
<i>Less:</i> (i) Cheques issued but not yet presented for payment	—	
(ii) Interest allowed by the bank	—	
(iii) Direct payment by customers into bank		
(iv) Interest on investment received by the bank	—	
(v) Dividend on shares collected by the bank	—	
(vi) Rebate on bills retired under rebate through the bank but full amount entered in the cash book		— (vii)
Any wrong entry on Cr. side of the pass book	—	—
Overdraft as per the Pass Book		—

If the reconciliation statement has been started with overdraft balance as per the pass book and to arrive at overdraft balance as per the cash book the entries made above should be reversed i.e. all added items should be deducted and deducted items should be added.

The above said procedure may be summarized as under :

<i>Transactions</i>	<i>Starting with Overdraft as per Cash Book</i>	<i>Starting with Overdraft as per Pass Book</i>
(i) Cheques issued but not presented	<i>Deduct :</i> The amount of unrepresented cheques.	<i>Add :</i> The amount of unrepresented cheques.
(ii) Cheques deposited but not yet collected	<i>Add :</i> The amount of cheques deposited	<i>Deduct :</i> The amount of cheques deposited
(iii) Cheques received entered in the bank column of the cash book but not deposited	<i>Add :</i> The amount of cheques deposited.	<i>Deduct :</i> The amount of cheques deposited.
(iv) Dishonour of cheques deposited earlier	<i>Add :</i> The amount of dishonoured cheques	<i>Deduct :</i> The amount of dishonoured cheques
(v) Collection of interest and dividends and interest allowed by the banker	<i>Deduct :</i> The amount of these items	<i>Add :</i> The amount of these items.

(vi) Bank charges	<i>Add</i> : The amount of bank charges	<i>Deduct</i> : The amount of charges.
Balance	Bank Balance as per Pass Book	Bank Balance as per Cash Book

Another method is to keep two columns 'Plus' and 'Minus'. All additions are to be shown in 'plus' column while all deductions in the 'minus' column. Balance is to be shown in 'plus' column while overdraft is shown in 'minus' column.

In some instances students are given extracts from the cash book and the pass book and is required to find out causes of differences and prepare reconciliation statement. In solving such problem the following points should be noted:

- (i) Heading of the pass book, and
- (ii) Period for which cash book and pass book are given.

Heading of the pass book is given in two ways:

- (a) Party in account with bank, and
- (b) Bank in account with party.

In the first instance, pass book is a copy of party's account in the books of bank and in the second case, pass book is the copy of bank's account (so far as it relates to the party) in the books of bank. Generally, pass book is written in the first form where it represents party's account, then debit side of the cash book is compared with credit side/column of the pass book and *vice-versa*. If the pass book is headed in the second form then debit side of the cash book is compared with the debit side/ column of the pass book and credit side with credit side/column.

In the practical field upto date bank statement is obtained and the cash book is amended by incorporating only those transactions in respect of which entries have been made in the pass book. The errors in the cash book are also rectified by suitable entries and thus the upto date bank balance as per cash book is obtained. This balance appears in the balance sheet. For examination purpose also a reconciliation statement may be prepared after amending the cash book especially if it is mentioned and when a reconciliation statement is prepared as on the date of closing the books of account.

Illustration 1

On 31st March, 2007 the pass book of Mitra showed a credit balance of Rs. 2,16,000. A comparison of pass book and cash book revealed the following:

	Rs.
(i) Cheques deposited but not yet cleared by 31st March	1,08,150
(ii) Cheques issued by Mitra but not yet presented for payment before 1st April, 2007	26,000
(iii) Insurance premium paid by bank on behalf of Mitra but not yet recorded in cash book	52,075
(iv) Commission charged by bank not yet recorded in cash book	750
(v) Interest on bonds collected by bank on behalf of Mitra not yet recorded in cash book	25,000

Bank balance as per cash book as on 31st March, 2007 is Rs. 3,25,975.

Prepare a Bank Reconciliation Statement as on 31st March, 2007.

Solution:

**Bank Reconciliation Statement of Mitra
as on 31st March, 2007**

<i>Particulars</i>	<i>Amount</i>	<i>Amount</i>
	<i>Rs.</i>	<i>Rs.</i>
Bank balance as per pass book		2,16,000
<i>Add :</i> Cheques deposited but not cleared	1,08,150	
Insurance premium paid by bank on behalf of Mr. Mitra not recorded in cash book as yet	52,075	
Bank commission not recorded in cash book	<u>750</u>	<u>1,60,975</u>
		3,76,975
<i>Less :</i> Cheques issued by Mitra but not yet presented to bank for payment	26,000	
Interest on bonds collected by bank on behalf of Mitra not recorded in cash book	<u>25,000</u>	<u>51,000</u>
Balance as per cash book		<u>3,25,975</u>

The abovementioned bank reconciliation statement could also be prepared as follows:

<i>Particulars</i>	<i>Amount</i>	<i>Amount</i>
	<i>Rs.</i>	<i>Rs.</i>
Balance as per cash book		3,25,975
<i>Add :</i> Cheques issued but not yet presented for payments to bank	26,000	
Interest on bonds collected by bank	<u>25,000</u>	<u>51,000</u>
		3,76,975
<i>Less :</i> Cheques deposited but not cleared	1,08,150	
Insurance premium paid by bank	52,075	
Commission charged by the bank	<u>750</u>	<u>1,60,975</u>
Balance as per pass book		<u>2,16,000</u>

Illustration 2

The cash book of Shri Gupta showed an overdraft of Rs. 30,000 on 31.3.2007. The scrutiny of the entries in the cash book and the pass book revealed that :

- (a) On 22nd March, cheques totalling Rs. 6,000 were sent to bankers for collection, out of these, a cheque of Rs. 1,000 was wrongly recorded in the credit side of the cash book and cheques amounting to Rs. 300 could not be collected by bank within the year.
- (b) A cheque for Rs. 4,000 was issued to a supplier on 28th March, 2007. The cheque was presented to bank on 4th April, 2007.
- (c) There were debits in the pass book for interest Rs. 2,000 on overdraft and bank charges Rs. 600 not recorded in the cash book.
- (d) The credit side of the bank column of the cash book was undercast by Rs. 100.
- (e) A cheque for Rs. 1,000 was issued to a creditor on 27th March, but unfortunately the same was not recorded in the cash book. The cheque was, however, duly encashed within 31st March.

- (f) As per standing instructions the banker collected dividend of Rs. 500 on behalf of Gupta and credited same to his account within 31st March, 2007. The fact was however intimated to Gupta on 3rd April, 2007.

You are required to prepare a bank reconciliation statement as on 31st March, 2007.

Solution:

Shri Gupta
Bank Reconciliation Statement as on 31.3.2007

	Rs.	Rs.
Bank overdraft as per cash book		30,000
<i>Add :</i> (i) Cheques deposited but not collected	300	
(ii) Debit in the pass book for interest on overdraft and bank charges not recorded in the cash book (2,000 + 600)	2,600	
(iii) Credit side of the bank column of the cash book undercast	100	
(iv) Cheques issued to creditor not recorded in the cash book but it was duly encashed by 31st March	<u>1,000</u>	<u>4,000</u>
		34,000
<i>Less :</i> (i) Cheques wrongly recorded in the credit side of the cash book (Rs. 1,000 x 2)	2,000	
(ii) Cheques issued but not yet presented for payment	4,000	
(iii) Dividend collected by the bank but not recorded in the cash book	<u>500</u>	<u>6,500</u>
Bank overdraft as per pass book		<u>27,500</u>

Illustration 3

From the following information, prepare Bank Reconciliation Statement as on 31st March, 2007:

Cash Book of Mr. S. Ray
(Bank Column only)

<i>Date</i>	<i>Particulars</i>	<i>Amount</i>	<i>Date</i>	<i>Particulars</i>	<i>Amount</i>
		<i>Rs.</i>			<i>Rs.</i>
2007			2007		
Mar. 1	To Balance b/d	7,000	Mar. 5	By Drawings	5,000
" 5	" Manohar Lal	4,000	" 8	" Interest	150

"	10	"	Deepak Kumar	10,000	"	10	"	Cheque Book	100
"	17	"	Sher Singh	13,000	"	15	"	Salaries	3,500
"	25	"	Mohan Lal	4,000	"	17	"	Ajit Singh	4,000
"	31	"	Harish Kumar	1,900	"	21	"	Abdul & Co.	5,000
					"	25	"	Karim & Sons	7,000
					"	30	"	Harish & Co.	1,000
					"	31	"	Balance c/d	<u>14,150</u>
				<u>39,900</u>					<u>39,900</u>

Bank Pass Book
(Bank in Account with Mr. S. Ray)

<i>Date</i>		<i>Particulars</i>	<i>Amount</i>	<i>Date</i>		<i>Particulars</i>	<i>Amount</i>
		<i>Rs.</i>				<i>Rs.</i>	
2007				2007			
Mar.	1	To Balance b/d	7,000	Mar.	5	By Drawings	5,000
"	8	" Manohar Lal	4,000	"	8	" Interest	150
"	15	" Deepak Kumar	10,000	"	10	" Cheque Book	100
"	24	" Sher Singh	13,000	"	15	" Salaries	3,500
"	28	" Interest on		"	22	" Ajit Singh	4,000
		Investment	1,200	"	29	" Abdul & Co.	5,000
"	30	" Rent	300	"	31	" Bank charges	32
"	31	" Bhura Mal	800	"	31	" Electricity charges	78
				"	31	" Balance c/d	<u>18,440</u>
			<u>36,300</u>				<u>36,300</u>

Solution:

**Bank Reconciliation Statement
as at 31st March, 2007**

	<i>Rs.</i>	<i>Rs.</i>
Balance as per cash book		14,150
<i>Add :</i> Cheques issued but not presented for payment	8,000	
Interest on investment collected by bank	1,200	
Rent collected by bank	300	
Direct deposit by the customer	<u>800</u>	<u>10,300</u>
		24,450
<i>Less :</i> Cheques deposited but not yet collected	5,900	
Bank charges	32	
Electricity charges	<u>78</u>	<u>6,010</u>
Balance as per pass book		<u>18,440</u>

Illustration 4

On 30th April, 2007 the cash book of Sircar showed a bank overdraft of Rs. 1,970. A comparison of entries in the pass book with those in the cash book revealed the following:

Cheques deposited with the bank but not yet credited in the pass book Rs. 8,505.

Cheques issued by Sircar but not yet presented by payees to bank for payment Rs. 12,500.

Interest on fixed deposit credited by bank under standing instructions but not yet recorded in cash book Rs. 650.

Prepare bank reconciliation statement as on 30th April, 2007 to ascertain the balance as per pass book.

Solution:

**Mr. Sircar
Bank Reconciliation Statement as at 30th April, 2007**

<i>Particulars</i>		<i>Amount</i>
		<i>Rs.</i>
Overdraft as per cash book		1,970
<i>Add :</i> Cheques deposited with the bank but not yet credited in pass book		<u>8,505</u>
		10,475
<i>Less :</i> Cheques issued but not yet presented to bank for payment	12,500	
Interest on fixed deposit credited by bank under standing instructions	<u>650</u>	<u>13,150</u>
Balance as per pass book		<u>2,675</u>

Illustration 5

On 30th April, 2007 pass book of Ghosh showed a debit balance of Rs. 32,675. You are required to prepare bank reconciliation statement taking into consideration the following information:

	Rs.
Cheques issued but not yet presented for payment	18,513
Cheques deposited with bank	1,38,000
But so far credited in the pass book	1,12,000
Interest collected by the bank but not recorded in cash book by Ghosh	1,200
Bank charges not yet entered in cash book	150

Solution:

Mr. Ghosh
Bank Reconciliation Statement as at April 30, 2007

<i>Particulars</i>	<i>Amount</i>	<i>Amount</i>
	<i>Rs.</i>	<i>Rs.</i>
Overdraft as per pass book		32,675
<i>Add :</i> Cheques issued but not yet presented for payment	18,513	
Interest collected by bank but not yet recorded in cash book by Ghosh	<u>1,200</u>	<u>19,713</u>
		52,388
<i>Less :</i> Cheques deposited with bank not yet credited in pass book	26,000	
Bank charges not yet entered in cash book	<u>150</u>	<u>26,150</u>
Overdraft as per cash book		<u>26,238</u>

The bank reconciliation statement can also be prepared by having two amount columns, one for the amounts that increase the positive balance (or reduce the overdraft) and for those that reduce positive balance (or increase the overdraft). The first may be headed “+” and the second “-” the opening balance is first entered in the appropriate column and finally the two columns are balanced. The illustration given above is solved below in the manner just stated:

Mr. Ghosh
Bank Reconciliation Statement as at April 30, 2007

	(+)	(-)
	<i>Rs.</i>	<i>Rs.</i>
Overdraft as per pass book		32,675

Cheques issued but not yet presented		18,513
Cheques deposited, not yet cleared	26,000	
Interest collected by the bank but not yet entered in the cash book		1,200
Bank charges, not yet entered in the cash book	150	
Overdraft as per cash book	<u>26,238</u>	<u>52,388</u>
	<u>52,388</u>	<u>52,388</u>

Before preparing bank reconciliation, entries should have been passed in cash book for transactions which have been recorded in pass book and not in cash book so far. In such a case, bank reconciliation statement is prepared on the basis of cash book balance resulting after such entries have been prepared. Such bank reconciliation statement will have only two items causing difference viz, cheques deposited but not yet cleared and cheques issued but not yet presented for payment. This is imperative when the accounting year is ending.

Illustration 6

Taking the data given in the previous illustration, find out the balance as per cash book after it has been brought up-to-date.

Prepare a bank reconciliation statement starting with the new balance as per cash book.

Solution :

In the previous illustration, bank balance as per cash book before it has been brought up-to-date has been ascertained. We can now proceed to ascertain the new bank balance.

	Rs.
Overdraft as per cash book (as ascertained in previous illustration)	26,238
Add : Bank charges	<u>150</u>
	26,388
Less : Interest collected by bank	<u>1,200</u>
Bank overdraft as per cash book (corrected)	<u>25,188</u>

Bank Reconciliation Statement of Ghosh as on 30th April, 2007

Particulars	Amount
	Rs.
Overdraft as per Cash Book	25,188
Add : Cheques deposited but not yet credited by bank	<u>26,000</u>
	51,188
Less : Cheques issued but not yet presented by payment	<u>18,513</u>
Balance as per pass book (Overdraft)	<u>32,675</u>

Illustration 7

On 31st March, 2007, the cash book of Ajay Ghosh showed a bank overdraft of Rs. 3,458. On examination of the cash book and bank statement, the following discrepancies were noted:

- (i) Cheques issued for Rs.1,200 were entered in the cash book but were not presented at the bank till first week of April, 2007.
- (ii) Cheques amounting to Rs. 1,000 were entered in the cash book on 30th March, 2007 but were banked on 2nd April, 2007.
- (iii) Cheques amounting to Rs. 500 were deposited in the bank but were not collected till March 31st, 2007.
- (iv) A cheque for Rs. 300 received from Mr. Dass Gupta and deposited in the bank was dishonoured but advice of non-payment was not received from the bank upto 31st March.
- (v) Rs. 3,000 being the proceeds of a bill collected on 20th March did not appear in the cash book.
- (vi) Rs. 300 being the proceeds of a bill collected on 20th March was omitted to be credited in the pass book.
- (vii) The pass book showed an amount of Rs. 340, being rent which his tenant Madan Gopal had directly deposited on the bank on 31st March, 2007.
- (viii) A bill payable of Rs. 600 was duly paid off on 31st March according to the instructions of Ajay Ghosh but this was not entered in cash book.
- (ix) Bank charges of Rs. 30 and interest on overdraft Rs. 170 appeared in the pass book but not in the cash book.

Prepare a bank reconciliation statement and find out the balance as per pass book.

Solution:

Ajay Ghosh
Bank Reconciliation Statement as on 31st March, 2007

	Rs.	Rs.
Overdraft as per cash book		3,458
Add : Items increasing overdraft in pass book:		
Cheques entered in cash book but not banked	1,000	
Cheques deposited but not collected	500	
Cheques deposited but dishonoured	300	
Bill collected but omitted to be entered in pass book	300	
Pay off of bills payable not entered in cash book	600	
Bank charges	30	
Interest on overdraft	<u>170</u>	
		<u>2,900</u>
		6,358
Less : Items reducing overdraft in pass book:		
Cheques issued, not presented for payment	1,200	
Bill collected, not entered in cash book	3,000	
Direct deposit of rent into bank	<u>340</u>	
Overdraft as per pass book		<u>4,540</u>
		<u>1,818</u>

Illustration 8

From the following information supplied by Shri Mehta prepare his bank reconciliation statement as on 31st March, 2007 after amending the Cash Book on that date:

	Rs.
1. Bank overdraft as per bank statement	1,65,000
2. Cheques issued but not presented for payment	87,500
3. Cheques deposited with the bank but not collected	1,05,000
4. Cheque recorded in the bank column of the cash book but not sent to the bank for collection	20,000
5. Payments received from customers direct by the bank	35,000
6. Bank charges debited in the statement	200
7. A bill for Rs. 30,000 (discounted with the bank in February at Rs. 29,780) dishonored on 31st March and noting charges paid by the bank	100
8. Premium on life policy of Mehta paid by the bank on standing advice	1,800
9. Overdraft balance (Cr.) on 25.3.2007, Rs. 80,000 carried over as debit balance on the next day.	

Solution:

Cash Book (Bank Column only)			
Dr.			Cr.
31.3.2007	Rs.	31.3.2007	Rs.
To Balance b/d (balancing fig.)	29,600	By Bank charges	200
" Customer (amount directly collected by Bank)	35,000	" Customer (discounted bill dishonoured and noting charges paid by bank)	30,100*
" Balance c/d	1,27,500	" Drawings (life insurance premium paid by bank)	1,800
		" Error (overdraft balance carried over as debit balance)	1,60,000**
	<u>1,92,100</u>		<u>1,92,100</u>
		1.4.2007	
		By Balance b/d	1,27,500

Notes: *Discounted value of the bill is immaterial here, because on dishonour the bank has debited the pass book with Rs. 30,100.

**Overdraft credit balance means overdraft balance as per Cash Book.

Bank Reconciliation Statement of Shri Mehta as on 31st March, 2007

	Rs.
Bank balance as per bank statement (overdraft)	1,65,000
Add: Cheques issued but not presented for payment	<u>87,500</u>
	2,52,500

Less: Cheques deposited with the bank but not collected	1,05,000	
Cheques recorded in cash book but not sent to bank for collection	<u>20,000</u>	<u>1,25,000</u>
Bank balance as per cash book (overdraft)		<u>1,27,500</u>

Illustration 9

On 31st March 2007, the cash book of a trader showed a bank overdraft of Rs. 15,280. On a comparison of the cash book with the bank pass book, the trader ascertained the following differences.

	(Rs.)
Cheques deposited with bank, but not credited by the bank	20,000
Interest on securities collected by the bank, but not yet recorded in the cash book	2,560
Dividend collected by the bank, but not yet recorded in the cash book	2,000
Cheques issued, but not yet presented to the bank for payment	74,800
Bank charges not yet recorded in the cash book	680

Solution:

Bank Reconciliation Statement as on 31st March 2007

Particulars	Plus items (Rs.)	Minus items (Rs.)
Overdraft as per cash book		15,280
Cheques deposited with the bank but not yet credited by bank		20,000
Interest on securities collected by the bank, but not yet recorded in the cash book	2,560	
Dividend collected by the bank, but not yet recorded in the cash book	2,000	
Cheques issued, but not yet presented to the bank for payment	74,800	
Bank charges not yet recorded in the cash book	<u>680</u>	<u>680</u>
	<u>79,360</u>	<u>35,960</u>

Balance as per pass book = Rs. 79,360 – Rs. 35,960 = Rs. 43,400.

Dr.		Cash Book (Bank Columns only)		Cr.	
Particulars		Rs.	Particulars		Rs.
To Interest on securities		2,560	By Balance b/d	15,280	
To Dividends received		2,000	By Bank charges	680	
To Balance c/d		11,400			
		<u>15,960</u>		<u>15,960</u>	
			By Balance b/d	11,400	

Illustration 10

The following is a summary of the Cash Book of Shri Mohan Das, for the month of June 2007.

	Rs.		Rs.
Receipts	14,690	Balance b/d	7,610
Balance c/d	<u>5,540</u>	Payments	<u>12,620</u>
	<u>20,230</u>		<u>20,230</u>

All receipts are banked and payments are made by cheque.

On investigation it is found that:

- (1) Bank charges of Rs. 1,360 entered on the bank statement had not been entered in the cash book.
- (2) Cheques drawn amounting to Rs. 2,670 had not been presented to the bank for payment.
- (3) Cheques received totaling Rs. 17,620 had been entered in the cash book and paid into the bank, but had not been credited by the bank until July, 2007.
- (4) A cheque for Rs. 1,220 had been entered as a receipt in the cash book instead of as a payment.
- (5) A cheque for Rs. 1,250 had been debited by the bank in error.
- (6) A cheque received for Rs. 800 had been dishonoured. No adjustments had been made in the cash book.
- (7) All dividends receivable are credited directly to the bank account. During June, amount totaling Rs. 2,620 were credited by the bank and no entries were made in the cash book.
- (8) A cheque drawn for Rs. 600 in favour of a creditor had been incorrectly entered in the cash book as Rs. 6,000.
- (9) The balance brought forward should have been Rs. 7,110
- (10) The bank statement as on 30th June, 2007, showed an overdraft Rs. 17,820.

You are required to:

- (a) Show the adjustments required in the cash book; and
- (b) Prepare a bank reconciliation statement as on 30th June, 2007.

Solution:

Shri Mohan Das Cash Book			
<i>Dr.</i>	<i>(Bank column only)</i>		<i>Cr.</i>
30.6.2007	Rs.	30.6.2007	Rs.
To Dividend	2,620	By Balance b/d	5,540
To Creditor - cheque drawn for Rs. 600 wrongly entered as Rs. 6,000	5,400	By Bank charges	1,360
To Error - wrong carry forward of balance on 1st June, 2007	500	By Error - cheque issued wrongly entered as received Rs. 1,220	2,440
To Balance c/d	<u>1,620</u>	By Customer - cheque returned	800
	<u>10,140</u>		<u>10,140</u>

**Bank Reconciliation Statement
as on 30th June, 2007**

	<i>Rs.</i>	<i>Rs.</i>
Bank balance as per cash book (overdraft)		1,620
<i>Add :</i> Cheques deposited but not credited by the bank until after 30th June, 2007	17,620	
Cheque debited by the bank in error	<u>1,250</u>	<u>18,870</u>
		20,490

Less : Cheque issued but not presented for payment	<u>2,670</u>
Bank balance as per bank statement (overdraft)	<u>17,820</u>

SELF-TEST QUESTIONS

1. What is bank reconciliation statement ? Why is it prepared ?
2. Describe the reasons why bank balance as per cash book may not agree with the bank balance as per pass book.
3. On 31st March, 2007 the cash book of Gupta showed a debit bank balance of Rs. 4,800. Prepare a bank reconciliation statement as at that date taking into account the following additional information:
 - (i) Cheques deposited but not yet credited by bank Rs. 3,610.
 - (ii) Cheques issued but not yet presented by payees for payments in the bank Rs. 2,050.
 - (iii) Bank charges appearing in pass book but not yet recorded in cash book Rs. 40.
 - (iv) Collections made by the bank and appearing in pass book but not yet recorded in cash book; Rs. 1,000.

[Balance as per Pass Book Rs. 4,200].

4. On 31st March, 2007 the cash book of a trader shows a bank overdraft of Rs. 1,800. A comparison of the cash book with the pass book reveals the following facts:
 - (i) Cheques issued but not presented for payment upto 31st March, 2007 Rs. 8,500.
 - (ii) Cheques deposited with the bank on 31st March, 2006 but credited by bank on 1st April, 2007 Rs. 9,200.
 - (iii) Bank charges debited by bank, Rs. 230 and dividends collected by bank on behalf of the trader Rs. 5,000 have not been recorded in the cash book.
 - (iv) A cheque of Rs. 1,400 received from X and deposited with the bank on 26th March, 2007 was recorded as that of Rs. 400 in the cash book.

You are required to prepare a bank reconciliation statement after passing the necessary entries in the cash book to bring its balance up-to-date. The firm closes the books on 31st March. How much will be shown in the balance sheet as bank balance/overdraft?

(Balance as per Pass Book Rs. 3,270; Correct cash book balance Rs. 3,970.)

5. Following are transactions recorded in the bank column of the Cash Book of Madhuri for the month ending 31 December, 2007:

Cash Book (Bank Column)

Date	Particulars	Rs.	Date	Particulars	Rs.
2007			2007		
Dec. 19	To Cash	54,000	Dec. 1	By Balance b/d	60,000
" 24	" Buddha	36,000	" 8	" Ram	3,000
" 26	" Chaitanya	15,000	" 10	" Lakshman	600
" 31	" Balance c/d	11,460	" 19	" Bharat	360
			" 24	" Shatrughan	<u>52,500</u>
		<u>1,16,460</u>			<u>1,16,460</u>

On the receipt of Bank Statement on 31st December, 2007, Madhuri collected the following information:

- (i) Credit transfer not recorded in the cash book Rs. 300
- (ii) Interest on Government bonds collected by the bank but not entered in the cash book Rs. 1,620.
- (iii) Cheques for Rs. 20,000 deposited but the bank collected only Rs. 5,000.
- (iv) Dividend collected by the bank directly but not intimated the same to Madhuri Rs.

1,500.

- (v) Bank charges recorded twice in the cash book Rs. 510.
- (vi) Interest on overdraft charged by the bank but not entered in the cash book Rs. 1,500.
- (vii) Cheques for Rs. 66,100 issued by the trader but presented to the bank for payment only Rs. 10,000.

Amend the Cash Book and prepare a Bank Reconciliation Statement from the above information.

Suggested Readings :

- (1) *R.L. Gupta and V.K. Gupta* — Financial Accounting
 - (2) *S.N. Maheshwari* — Financial Accounting
 - (3) *J.R. Monga* — Advanced Financial Accounting
 - (4) *S.P. Jain and K.L. Narang* — Financial Accounting
-

STUDY IV

RECTIFICATION OF ERRORS

1. INTRODUCTION

While discussing about the trial balance we have seen that preparation of trial balance is a method of verifying the arithmetical accuracy of entries made in the ledger. But it may be noted that an agreement in the trial balance does not prove that- (i) all transactions have been correctly analysed and recorded in the proper accounts; and (ii) all transactions have been recorded in the books of original entry. Hence we can say that a trial balance should not be regarded as a conclusive proof of the correctness of the books of account, that if the trial balance does not agree, there are errors or mistakes and if the trial balance does agree, there may be errors in the accounts.

Errors are rectified due to the following reasons:

- (i) Presenting the correctly recorded accounting information.
- (ii) Profit and loss account is prepared to show the accurate profit or loss made during the year for which corrected accounting figures are necessary.
- (iii) Disclosing the true financial position for preparing the balance sheet with correctly recorded figures.

2. CLASSIFICATION OF ERRORS

Accounting errors are generally of two types viz. (a) Errors of principle and (b) Clerical errors:

(a) *Errors of Principle*

These errors arise because of an incorrect application of the fundamental principles of double entry system of accounting i.e. not as per the rules of debit and credit or in violation of some other basic principle such as the failure to differentiate between capital and revenue etc. The distinction between capital and revenue is of relevance because any incorrect adjustment or allocation in this respect would falsify the final results shown by the profit and loss account and balance sheet.

(b) *Clerical Errors*

These errors do not reflect lack of knowledge of the basic principles of book- keeping but only

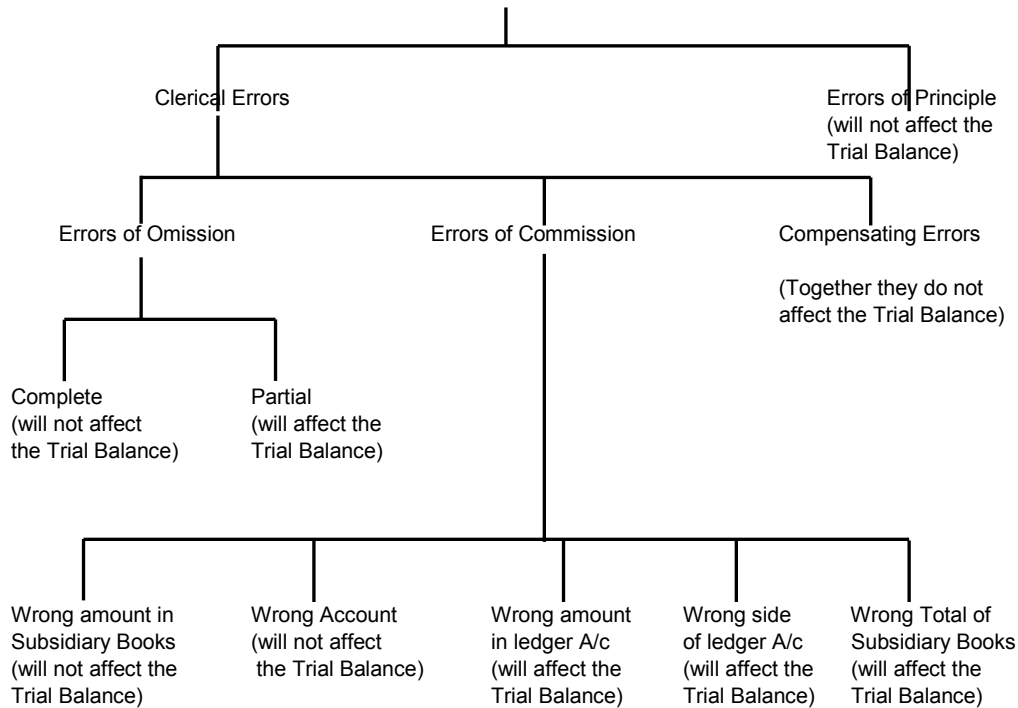
routine errors due to negligence, overlook etc. The following are clerical errors.

- (i) *Errors of Commission* : These errors arise due to some positive act of commission on the part of the person responsible for the maintenance of the books of account. These mistakes are committed because of ignorance, lack of proper accounting knowledge and carelessness of the accounting staff. They are committed while recording transactions. Examples:
 - (a) Mistake in transferring the balance of an account to the trial balance or omitting to write the balance of an account in the trial balance.
 - (b) Mistake in balancing an account.
 - (c) Mistake in posting in so far as the amount is wrongly written. A common mistake, for example, is to transpose figures - to write Rs. 115 instead of Rs. 151. This will cause a mistake of Rs. 36 and a corresponding difference in the trial balance. The total of all the figures of the difference thus caused is 9 or multiples of 9. (Students should note that in case of transposition of figures, (i) the difference in trial balance will always be divisible by 9, (ii) the total of all the figures of the difference will also be divisible 9. Suppose you have written 67895 instead of 95678 or in any other way, provided the figures are the same, the difference 27783 (i.e. 95678 - 67895) is divisible by 9. Also, the total of the figures, i.e., $2 + 7 + 7 + 8 + 3 = 27$ is also divisible by 9. Therefore, always total the figures of the difference in trial balance and then divide it by 9 or divide the difference in trial balance by 9 and if it is divisible, there is transposition of figures.
 - (d) Making an entry on the wrong side. For example, if instead of debiting an account with Rs. 500 it is credited with the amount, the debit balance, in the trial balance will be shorter by Rs. 1,000. A mistake on the wrong side causes double the difference.
 - (e) A mistake in the casting of subsidiary books. A mistake in the total of the Purchases Book will affect the Purchases Account, a mistake in the total of the Sales Book will mean a corresponding mistake in the Sales Account. Similarly, total of the Returns Book, if wrongly done, would mean that the Returns Inwards Account or Returns Outwards Account will be posted with wrong amounts. These mistakes will be reflected in the trial balance.

It must be noted that a mistake in the totals of the subsidiary books will not affect the correctness of the various personal accounts of customers and creditors.
- (ii) *Errors of Omission* : These errors arise as a result of some act of omission on the part of the person responsible for the maintenance of books of account. It can be in two ways:
 - (a) Complete Omission : When any particular transaction has not at all been entered in the journal or in the book of original entry, it can not be posted into the ledger at all and a complete errors of omission will occur. The trial balance is not affected at all by such errors e.g. failure to record completely credit sales in Sales Book.
 - (b) Partial Omission : This means that the transaction is entered in the subsidiary books, but is not posted to the ledger, such errors affect the agreement of trial balance e.g. Omitting to post the discount columns of the cash book.
- (iii) *Compensating Errors* : They are group of errors, the total effect of which are not reflected in the trial balance. These errors are of neutralising in nature, hence one error is compensated by other error or errors of an opposite nature. For example an extra debit in purchase account may be compensated by an extra credit in sales account.

The following chart gives the various types of errors:

Errors



3. ERRORS WHICH AFFECT THE AGREEMENT OF TRIAL BALANCE

These are errors which are disclosed by the trial balance by its disagreement of both sides. Trial balance in general, discloses any error which affects one side of the account.

Following are some examples:

- (i) Error in casting the books of subsidiary books.
- (ii) Error in carrying forward the total of one page to another page.
- (iii) Error in totalling the trial balance.
- (iv) Error in posting from the books of subsidiary record to ledger.
- (v) Error in balancing the account.
- (vi) Error in preparation of debtor's schedule and creditors' schedule.
- (vii) Error in carrying forward a balance of an account to the trial balance.
- (viii) Omission of casting etc.
- (ix) Posting an amount on the wrong side of a ledger account.
- (x) Double posting to one account.
- (xi) Omission of an amount from trial balance.

4. ERRORS NOT DISCLOSED BY TRIAL BALANCE

The agreement of a trial balance is only a check of arithmetical accuracy of the ledger but it is not a conclusive proof as to the absolute accuracy of the books. The following errors will not effect the agreement of trial balance:

- (i) *Errors of Omission* : If a transaction was not journalised or it is not posted in the ledger the agreement of the trial balance will not be affected. For example, if goods worth Rs. 2,000 have been received back from a customer and the entry has not at all been made in the Returns Inwards Book. In that case, the Customer's Account will not be credited and the Returns Inwards Account also will not be debited. Thus, there is no debit and credit and the trial balance will still agree.

- (ii) *Errors of Commission* : If a transaction was debited or credited to a wrong account with correct amount and on the correct side in the books of original entry or in the ledger, trial balance will remain unaffected.
- (iii) *Compensatory Errors* : These are errors which are neutralised by the commission of another error or errors of the same magnitude but of opposite nature, which makes the trial balance to agree. For instance, the overcasting of a sales book (say) Rs. 3,000 and thereby the excess credit to the sales account, will be arithmetically off-set either by over debiting or under crediting a single account or several accounts with a sum of Rs. 3,000.
- (iv) *Errors of Principle* : Errors in analysing transactions too do not hit the trial balance whenever the amount received or spent is not properly allocated between revenue and capital, the error so made is called an error of principle. If furniture purchased is debited to purchase account, building sold is credited to sales account, commission paid for purchase of land is debited to commission account etc. then the error of principle is committed. The trial balance will remain unaffected by such errors.
- (v) *Recording Wrong Amount* : If a wrong amount is written in subsidiary books, then entries on both the debit and credit sides will be on the basis of the wrong amount and then the trial balance will naturally agree.
- (vi) *Errors of Duplication* : This is the error of entering a transaction more than once in the accounts.

5. STEPS TO LOCATE ERRORS

Whenever there is difference in the trial balance even by the smallest amount, the mistakes involved must be located. A small amount may be the net result of a number of mistakes and it is not safe to ignore difference in trial balance howsoever, small it may be. The following steps are suggested to find out errors:

- (i) Total the Dr. and Cr. columns of the trial balance again. If one amount has been shown for a group of accounts (for example, in place of all customers individually, only one amount against "Sundry Debtors" may be shown), recheck the total of the list of such accounts.
- (ii) See that the balance of all accounts including the cash, bank balances have been written in the trial balance.
- (iii) See that there is no mistake in the balancing of the various accounts.
- (iv) Find out the exact difference in the trial balance. Look for such accounts which show the same amount. It is possible that the balance of the particular account has been omitted from the trial balance. Accounts showing a balance equal to half the difference should also be checked; the amount may have been written on the wrong side of the trial balance. If the total of all the figures of the difference comes to 9 or multiple of 9 it is possible that some figures have been transposed. This should be checked.
- (v) Recheck the totals of the subsidiary books.
- (vi) If the difference is a large one, compare the figures with the trial balance of the corresponding date of the previous year. Any account showing a rather large difference over the figures of the corresponding trial balance of the previous year should be rechecked.
- (vii) Posting of all the amounts corresponding to the difference or half the difference should be checked.
- (viii) If the difference is still not traced, posting of the accounts will have to be checked. For this it is better first of all, to check the posting of the totals of subsidiary books such as sales book, purchase book, returns books etc. The subsidiary books should then be gone through to see if any item have been left unposted. It should also be checked

whether the various accounts have been opened with correct balances. Nominal accounts should be checked first, then real accounts and then personal accounts should be taken up.

We now give a comprehensive illustration showing how transactions are first recorded in subsidiary books, posted into ledger and then how the trial balance is extracted.

Illustration 1

Record the following transaction in the books of accounts and prepare a trial balance as on 31st March, 2007.

Assets : Furniture Rs. 28,000; Manohar Lal Rs. 5,000; Big Bong Club Rs. 9,500; Stock of goods Rs. 58,600; Cash in Hand Rs. 4,600.

Liabilities : Bank overdraft Rs. 500; Britannia Biscuits Co. Rs. 7,600; Capital Rs. 97,600.

2007

- March 1 Cash sales Rs. 6,200.
- March 3 Deposited with the bank Rs. 4,000.
- March 7 Manohar Lal is declared insolvent and a first and a final dividend of Rs. 0.25 in a rupee is recieved.
- March 8 Paid cash to Britannia Biscuits Co., in full settlements of account Rs. 7,450.
- March 10 Purchased from Britannia Biscuits Co., on credit, biscuits Rs. 18,000 less trade discount @2%.
- March 14 Sold Goods to G.Grace on credit.
Biscuits Rs. 200; Choclates Rs. 50
Tomato sauce Rs. 60; Jam Rs. 150; Cheese Rs. 40.
Purchased furniture from Fancy Furniture Store on credit Rs. 2,000.
- March 17 Paid for stationery Rs. 220 and for repairs to old furniture Rs. 60.
- March 18 Cash sales Rs. 2,480.
- March 25 Sold to Big Bong Club on credit.
Biscuits Rs. 1,500, Sauce Rs. 150.
Cheque recieved from Big Bong Club for Rs. 4,900, cash discount allowed Rs. 100.
Bought of Kissan Products Co., on credit Rs. 2,000 - Jam.
- March 27 Cheque recieved from G.Grace in full settlement Rs. 480.
- March 31 Cash withdrawn from bank, Rs. 2,500.
Salary paid in cash, Rs. 4,000.
Rent paid by means of cheque Rs. 1,000.
Credit sale of biscuits of Nathu Ram Rs. 280.

Solution :

(Note : Some errors have been deliberately committed while solving the problem. Students should make a note of them and see what effect they have and how they are connected.

Purchases Book

Date	Particulars	L.F	Details	Amount
2007			Rs.	Rs.
March 10	Britannia Biscuits Co.			
	Biscuits		18,000	
	Less: Trade Discount @2%		<u>360</u>	17,640
March 25	Kissan Products Co.			<u>2,000</u>
				<u>19,640</u>

<i>Date</i>	<i>Particulars</i>	<i>L.F</i>	<i>Details</i>	<i>Amount</i>
2007			<i>Rs.</i>	<i>Rs.</i>
March 14	G.Grace			
	Biscuits		200	
	Choclates		50	
	Tomato Sauce		60	
	Jam		150	
	Cheese		<u>40</u>	500
March 25	Big Bong Club			
	Biscuits		1,500	
	Sauce		<u>150</u>	<u>1,650</u>
				<u>2,150</u>

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
2007			Rs.	Rs.
March 1	Furniture Account	Dr.	28,000	
	Manohar Lal	Dr.	5,000	
	Big Bong Club	Dr.	9,500	
	Stock of Goods Account	Dr.	58,600	
	Cash Account	Dr.	4,600	
	To Bank Overdraft			500
	To Britannia Biscuit Co.			7,600
	To Capital Account			97,600
	(For opening balances of various accounts as per last balance sheet)			
March 7	Bad Debts Account	Dr.	3,750	
	To Manohar Lal			3,750
	(For bad debt on the insolvency of Manohar Lal)			
March 14	Furniture Account	Dr.	2,000	
	To Fancy Furniture Stores			2,000
	(For credit purchase of Furniture)			

Dr.								Cr.			
Date	Particulars	L.F.	Disc.	Cash	Bank	Date	Particulars	L.F.	Disc.	Cash	Bank
2007	Rs.		Rs.			2007	Rs.		Rs.		
March 1	To Balance b/d			4,600		March 1	By Balance b/d				500
March 3	To Sales A/c			6,200		March 3	By Bank (C)			4,000	
March 3	To Cash (C)				4,000	March 8	By Britannia				

March 7 To Manohar Lal	1,250			Biscuits			
March 18 To Sales A/c	2,480			Co. Ltd.	150	7,450	
March 25 To Big Bong Club	100	4,900		March 17 By Stationery		220	
March 27 To G. Grace	20	480		March 17 By Furniture		60	
March 31 To Bank (C)	2,500			March 31 By Cash (C)			2,500
				March 31 By Salaries		4,000	
				March 31 By Rent		1,000	
				By Balance c/d		<u>1,300</u>	<u>5,380</u>
	<u>120</u>	<u>17,030</u>	<u>9,380</u>	<u>150</u>	<u>17,030</u>	<u>9,380</u>	
April 1 To Balance b/d		1,300	5,380				

**Ledger
Furniture Account**

<i>Dr.</i>				<i>Cr.</i>			
<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount</i>	<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount</i>
2007			<i>Rs.</i>	2007			<i>Rs.</i>
Mar. 1	To Balance b/d		28,000	Mar. 31	By Balance c/d		30,060
" 14	To Fancy Furnitures		2,000				
" 17	To Cash A/c		<u>60</u>				
			<u>30,060</u>				<u>30,060</u>
April 1	To Balance b/d		30,060				

Manoharlal

2007			<i>Rs.</i>	2007			<i>Rs.</i>
Mar. 1	To Balance b/d		5,000	Mar. 7	By Cash A/c		1,250
					By Bad Debts		<u>3,750</u>
			<u>5,000</u>				<u>5,000</u>

Big Bong Club

2007			<i>Rs.</i>	2007			<i>Rs.</i>
Mar. 1	To Balance b/d		9,500	Mar. 25	By Sales		1,050
				Mar. 25	By Bank A/c		4,900
				Mar. 25	By Discount		100
				Mar. 25	By Balance c/d		<u>3,450</u>
			<u>9,500</u>				<u>9,500</u>
Apr. 1	To Balance b/d		3,450				

Stock of Goods Account

2007			<i>Rs.</i>
Mar. 1	To Balance b/d		58,600

Britannia Biscuits Co.

2007			<i>Rs.</i>	2007			<i>Rs.</i>
Mar. 8	To Cash A/c		7,450	Mar. 1	By Balance b/d		7,600
Mar. 8	To Discount A/c		150	Mar. 10	By Purchases A/c		17,640
Mar. 31	To Balance c/d		<u>17,640</u>				
			<u>25,240</u>				<u>25,240</u>
				Apr. 1	By Balance b/d		17,640

G. Grace

2007			Rs.	2007		Rs.
Mar. 14	To	Sales A/c	500	Mar. 27	By Bank	480
					By Discount A/c	<u>20</u>
			<u>500</u>			<u>500</u>

Capital Account

<i>Dr.</i>				<i>Cr.</i>			
<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount</i>	<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount</i>
							<i>Rs.</i>
				2007			
				Mar. 1	By Balance b/d		97,600

Sales Account

2007			Rs.	2007		Rs.
Mar. 31	To	Balance c/d	10,830	Mar. 3	By Cash A/c	6,200
		Mar. 18			By Cash A/c	2,480
				Mar. 31	By Sundries as per	
					Sales Book	<u>2,150</u>
			<u>10,830</u>			<u>10,830</u>
				Apr. 1	By Balance b/d	10,830

Kissan Products Co.

			2007			Rs.
			Mar. 25	By Purchases		2,000

Purchases Account

2007			Rs.
Mar. 31	To	Sundries as per	
		Purchases Book	19,640

Bad Debts Account

2007			Rs.
Mar. 7	To	Manohar Lal	3,750

Fancy Furniture Stores

			2007			Rs.
			Mar. 14	By Furniture A/c		2,000

Stationery Account

2007			Rs.
Mar. 17	To	Cash A/c	220

Salaries Account

Dr.				Cr.			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
2007			Rs.				
Mar. 31	To Cash		4,000				

Rent Account

2007			Rs.				
Mar. 31	To Bank		1,000				

Trial Balance as on 31st March, 2007

Name of the Accounts	Dr. Balances	Cr. Balances
	Rs.	Rs.
Cash in Hand	1,300	
Cash at bank	5,380	
Furniture	30,060	
Big Bong Club	3,450	
Stock of goods (1. 3. 2007)	58,600	
Britannia Biscuits Co.		17,640
Capital Account		97,600
Sales		10,830
Kissan Products Ltd.		2,000
Purchases	19,640	
Bad Debts	3,750	
Fancy Furniture Store		2,000
Stationery Account	220	
Salaries Account	4,000	
Rent Account	1,000	
	<u>1,27,400</u>	<u>1,30,070</u>

The trial balance is seen by excess credit of Rs. 2,670. Now mark the following errors in the solution:

- (i) On 25th March, 2007 goods were sold to Big Bong Club for Rs. 1,650. The transaction has been correctly entered in the Sales Book. But while posting it in the ledger, the account of Big Bong Club has been credited with Rs. 1,050 instead of being debited with Rs. 1,650. To rectify this error the Big Bong Club, must be debited with Rs. 2,700 which means the balance on 1st April will be Rs. 6,150 instead of Rs. 3,450.
- (ii) Discount columns in the Cash Book have been ignored in as much as their totals have not been posted to Discount Account in the ledger. Discount Account when prepared will appear as follows :

Discount Account

Dr.	Cr.
-----	-----

<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount</i>	<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount</i>
2007			<i>Rs.</i>	2007			<i>Rs.</i>
Mar. 31	To Sundries for discount allowed as per debit side of Cash Book		120	Mar. 31	By Sundries for discount received as per credit side of Cash Book		150
" 31	To Balance c/d		<u>30</u> <u>150</u>				<u>150</u>
				Apr. 1	To Balance b/d		30

If at this stage, trial balance is prepared, it will agree at Rs. 1,30,100. But the following two errors remain unrectified:

- Rs. 60 paid for repairs to old furniture should have been debited to Repairs Account but actually have been debited to Furniture Account.
- Credit sale of Rs. 280 to Nathu Ram on 31st March has not been recorded at all.

Error (a) can be rectified by crediting Furniture Account with Rs. 60 to remove the unwanted debit and then by opening and debiting Repairs Account with Rs. 60.

To rectify errors (b) Nathu Ram will be debited and Sales Account credited with Rs. 280.

These two errors show that agreement of a trial balance does not mean complete absence of errors.

After all the errors have been rectified the trial balance will appear as follows:

Trial Balance as on 31st March, 2007

<i>Name of Accounts</i>	<i>Dr. Balances</i> <i>Rs.</i>	<i>Cr. Balance</i> <i>Rs.</i>
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>
Cash in hand	1,300	
Cash at bank	5,380	
Furniture	30,000	
Big Bong Club	6,150	
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>
Stock of Goods Account	58,600	
Britannia Biscuit Co.		17,640
Capital Account		97,600
Sales Account		11,110
Kissan Products Co.		2,000
Purchases Account	19,640	
Bad Debts Account	3,750	
Fancy Furniture Store		2,000
Stationery Account	220	
Salaries Account	4,000	
Rent Account	1,000	
Discount Account		30

Repairs Account	60	
Nathu Ram	280	
	<u>1,30,380</u>	<u>1,30,380</u>

6. RECTIFICATION OF ERRORS

It is better to rectify errors always through journal entries. However, if an error is located immediately after it has been entered, the accountant may neatly cross out the wrong amount and initial the rectification, overwriting must not be restored to. If however, some time has been elapsed between the commission of the error and its detection, the error should be rectified only by making suitable journal entries.

7. RECTIFICATION BEFORE THE PREPARATION OF TRIAL BALANCE

Errors are normally corrected before the preparation of final trial balance. When errors are detected before the preparation of the trial balance, it should be assessed whether they are of one sided errors or two sided errors. According to the nature of errors, different steps are taken for their rectification.

(a) *Errors Affecting One Account (One Sided Errors)* : Errors affect one account may occur due to the following reasons:

- (i) Wrong casting.
- (ii) Wrong balancing.
- (iii) Wrong posting.
- (iv) Wrong carrying forward.
- (v) Forgetting to show in the trial balance.

For rectification of these type of errors, no journal entry is required to be passed, only the relevant account, in the ledger to be debited (for short debit or excess credit) or to be credited (for short credit or excess debit) according to the situation.

While rectifying errors it should be remembered that in case of a one sided error, i.e. error in which only one side has been affected, the 'double entry' aspect or the entry rectifying the error will not be complete. For example, if P's account has been debited with Rs. 365 for credit sales of Rs. 356 correctly recorded in Sales Book, the rectifying entry will be of Rs. 9 made on the credit side of P's account. No account will be debited with this amount of Rs. 9.

Illustration 2

Rectify the following:

- (i) An entry for the goods sold to Madhav for Rs. 1,020 was posted to his account as Rs. 1,200.
- (ii) Rs. 1,000 being the monthly total of discount allowed to customers were credited to discount account in the ledger.
- (iii) Rs. 2,750 received from Sohan credited to Mohan as Rs. 3,750.
- (iv) The total of Purchases Book was Rs. 10,000 short.
- (v) Sales of old furniture for Rs. 1,750 to Old Wares Stores was recorded in Sales Book. Book value of the furniture was Rs. 2,500.

Solution :

- (i) Credit Madhav with Rs. 180 saying "By Excess debit for sales onRs. 180".
- (ii) Debit the Discount Account with Rs. 2,000 saying "To Rectification of wrong credit of Rs. 1,000 for discount allowed.... Rs. 2,000.

- (iii) Credit Sohan with Rs. 2,750 and debit Mohan with Rs. 3,750.
- (iv) Debit Purchase Account with Rs. 10,000 saying "To Short total of Purchases Book..... Rs. 10,000".
- (v) Debit Sales Account with Rs. 1,750 and Loss on Sale of Furniture Account with Rs. 750 and credit Furniture Account with Rs. 2,500.

(b) *Errors Affecting Two or More Accounts. (Two Sided Errors):* Errors which affect two or more accounts are as follows:

- (i) Errors of omission.
- (ii) Errors of recording.
- (iii) Errors of posting to wrong account with or without wrong amount.
- (iv) Errors of principle.

These types of errors have to be dealt on merit. The guiding lines are: Think about the transaction which have been wrongly recorded. Note which account should have been debited and which account should have been credited. Now consider what has actually been done. In order to ascertain the rectifying entries remember if some account to receive a debit and if it has not been debited, debit now. If some account was to receive a credit and has not been given credit, do so now. On the other hand, if some account has received an unwanted debit, credit the account to remove the debit and similarly if you find some account has received a credit by mistake, debit the account to remove the unwanted credit.

For rectification of these types of errors following steps may be taken:

- (i) Write down in the rough sheet the correct entry necessary for recording the transaction.
- (ii) Write down in the rough sheet the entry that has actually been passed.
- (iii) Pass in the journal the requisite entry to arrive at the correct entry of step (i) and cancel the entry of step (ii).

Example : A purchase of Rs. 5,000 from Rajesh entered in the purchases day book as Rs. 500. The rectification of this error shall call for:

(a) Purchases A/c	Dr. 5,000	correct entry
To Rajesh		5,000
(b) Purchases A/c	Dr. 500	entry passed
To Rajesh		500
(c) The rectifying entry in the journal will be:		
Purchases A/c	Dr. 4,500	rectifying entry
To Rajesh		4,500

Illustration 3

Pass journal entries necessary to rectify the following errors :

1. An amount of Rs. 2,000 withdrawn by the proprietor for his personal use has been debited to Trade Expenses Account.
2. A purchase of goods from Nathan amounting to Rs. 3,000 has been wrongly entered through the Sales Book.
3. A credit sale of Rs. 1,000 to Santhanam has been wrongly passed through the Purchases Book.
4. Rs. 1,500 received from Malhotra have been credited to Mehrotra.

5. Rs. 3,750 paid on account of salary to the cashier Dhawan stands debited to his personal account.
6. A contractor's bill for extension of premises amounting to Rs. 27,500 been debited to Building Repairs Account.
7. On 25th June, goods of the value of Rs. 5,000 were returned by Akash Deep and were taken into stock but the return's were entered in the Books under date 3rd July, i.e.; after the expiration of the financial year on 30th June.
8. A bill of Rs. 2,000 for old office furniture sold to Sethi were entered in the Sales Day Book.
9. An amount of Rs. 800 received on account of interest was credited to Commission Account.

Solution:

1.	Proprietor's Drawing Account	Dr.	Rs. 2,000	Rs.	
	To Trade Expenses				2,000
	(For the amount withdrawn for personal use wrongly charged to the latter account)				
			Rs.	Rs.	
2.	(a) Sales Account	Dr.	3,000		
	To Nathan				3,000
	(Being the cancellation of the entry passed through the Sales Book)				
	(b) Purchases Account	Dr.	3,000		
	To N'athan				3,000
	(To record the credit purchases from Nathan)				
	<i>Alternative y:</i> One combined entry can also be passed as under:				
	Sales Account	Dr.	Rs. 3,000	Rs.	
	Purchases Account	Dr.	3,000		
	To Nathan				6,000
	(For cancellation of entry passed through the Sales Book and record the credit purchases from Nathan)				
	(Note : Nathan should have been credited and Purchases Account is debited with Rs. 3,000 but the effect of the entry in the Sales Book is that Sales Account has been credited and Nathan is debited with Rs. 3,000. First entry is passed to cancel this wrong debit and credit and second entry to record the purchases made from Nathan. Thus, Nathan will be credited with Rs. 6,000 (Rs. 3,000 to remove the wrong debit and Rs.3,000 for correct credit).				
3.	Santhanam	Dr.	2,000		
	To Purchases Account				1,000
	To Sales Account				1,000
	(Rectification of the mistake caused by entering Rs. 1,000 to Santhanam in the Purchases Book)				
	<i>Note : Apply the reasons given in entry No. 2)</i>				
4.	Mehrotra	Dr.	1,500		

	To Malhotra		1,500
	(Being the rectification of wrong credit given to the former account)		
5.	Salaries Account	Dr. 3,750	
	To Dhawan		3,750
	(Being the adjustment of salary wrongly debited to the Personal Account of the cashier)		
		Rs.	Rs.
6.	Building Account	Dr. 27,500	
	To Building Repairs Account		27,500
	(Being the adjustment of amount wrongly debited to the latter account)		
7.	Return Inwards Account	Dr. 5,000	
	To Akash Deep		5,000
	(Being the entry necessary to record the return inwards within the financial year) Note: The entry passed to record the above returns made in 3rd July will have to be cancelled by passing a reverse entry under the same date i.e.:		
	Akash Deep	Dr. 5,000	
	To Return Inwards Account		5,000
8.	Sales Account	Dr. 2,000	
	To Office Furniture Account		2,000
	(Being the sale of old office Furniture wrongly passed through the Sales Book, error of principle)		
9.	Commission Account	Dr. 800	
	To Interest Account		800
	(Being the adjustment of amount wrongly credited to the former account)		

8. SUSPENSE ACCOUNT

When a trial balance does not agree, the difference in it is sometimes transferred to a Suspense Account in order to give trial balance an appearance of agreement. If the debits are short the difference has to be debited to Suspense Account and if the credits are short, Suspense Account has to be credited to make trial balance agree apparently.

When there is a Suspense Account, all the errors are rectified by means of journal entries, each one of them being complete in its double aspect. It is because, if in an entry debit is short of credit, the difference is debited to Suspense Account making the debits equal to the credits. Similarly, if in rectifying journal entry, credit is otherwise short of debit, the difference is credited to Suspense Account.

When all errors affecting the trial balance have been rectified by means of journal entries, the Suspense Account will show no balance. It follows from the fact the original entry in the Suspense Account was itself the net effect of all errors affecting the trial balance.

Sometimes a problem may not state the opening balance of the Suspense Account. This can be ascertained by preparing a Suspense Account after all the errors are corrected, treating the difference in Suspense Account as opening balance. Suppose, after the rectification of all the errors, the debit side of the Suspense Account totals Rs. 8,900 and credit side totals Rs. 7,800. The difference is Rs. 1,100 and should be placed at the top of the credit side of the suspense account as, By Difference in Trial Balance Rs. 1,100.

Problem given in Illustration 2 can be solved as under if there is a Suspense Account.

Journal Entries
(Without Narrations)

		Rs.	Rs.
(i)	Suspense Account To Madhav	Dr. 180	180
(ii)	Discount Account To Suspense Account	Dr. 2,000	2,000
(iii)	Mohan Account To Sohan To Suspense Account	Dr. 3,750	2,750 1,000
(iv)	Purchases Account To Suspense Account	Dr. 10,000	10,000
(v)	Sales Account Loss on Sale of Furniture To Furniture Account	Dr. 1,750 Dr. 750	2,500

Suspense Account

	Rs.		Rs.
To Difference in Trial balance (balancing fig.)	12,820	(ii) By Discount A/c (iii) By Mohan (iv) By Purchases A/c	2,000 1,000 10,000
(i) To Madhav	180		
	<u>13,000</u>		<u>13,000</u>

9. RECTIFICATION AFTER THE PREPARATION OF TRIAL BALANCE BUT BEFORE THE PREPARATION OF FINAL ACCOUNTS

(a) *In Case of One Sided Errors* : Every one sided error will be rectified by passing a journal entry through suspense account. A suspense account is opened in two instances i.e. (i) To balance a disagreed trial balance - In case the trial balance does not tally, the amount of difference is entered in the lighter column against suspense account. Thus, suspense account is opened in the ledger and is given the debit or credit as the case may be. Later when errors are detected, the rectifying entries are passed, (ii) To post uncertain items -sometimes, an item cannot be posted to the correct account for want of informations. For instance, you received a remittance of Rs. 2,000, but you may not know who has sent the amount. Therefore, for the time being you may pass the following entry:

Cash Account	Dr. 2,000	
To Suspense Account		2,000
(Being remittance received from unknown person)		

Later where you get the information that Mr. Ram Singh had sent the amount, then pass the following entry:

Suspense Account	Dr. 2,000	
To Ram Singh		2,000
(Being credit given for the sender for remittance which had been credited previously to suspense)		

account)

(b) *In Case of Two Sided Error:* For rectification of two sided errors, the following steps may be taken:

- (i) Write down in the rough sheet the correct entry necessary for recording the transaction.
- (ii) Write down in the rough sheet the entry that has actually passed.
- (iii) Pass in the journal, the requisite entry to arrive at the correct entry of step (i) and to cancel step (ii).

Example: Sale of old furniture has been credited to sales account for Rs. 3,000. The rectification of this error shall call for:

(a) Cash Account	Dr.	3,000	correct entry
To Furniture Account		3,000	
(b) Cash Account	Dr.	3,000	entry passed
To Sales Account		3,000	
(c) The rectifying journal entry will be:			
Sales Account	Dr.	3,000	rectifying entry
To Furniture Account		3,000	

10. RECTIFICATION IN THE NEXT ACCOUNTING PERIOD

If error of one accounting period are to be rectified in a subsequent accounting period, care has to be taken that the rectifying entry, does not affect the trading results of the subsequent accounting period. For example, to debit sales account in 2006-07 to rectify an error in Sales Account for 2005-06 also falsifies the accounts for 2006-07. Hence, the proper method is to open a Profit and Loss Adjustment Account and debit it for all debit required in nominal account and similarly credit it for all requisite credits to nominal accounts to rectify errors. In other words, Profit and Loss Adjustment Account serves the purpose all nominal accounts as far as rectification of errors belonging to a previous period is concerned. Profit and Loss Adjustment Account is Transferred to Capital Account. In the case of a joint stock company the account is transferred to Profit and Loss Appropriation Account. The use of suspense account is made wherever necessary.

Examples:

- (a) Wages of Rs. 2,500 paid for the installation of machinery charged to wages account. In the normal course, the rectifying entry would be:

Machinery Account	Dr.	2,500	
To Wages Account			2,500

Since the final accounts have been prepared, the wages account has been closed by transferring trading account, so the rectifying entry will be:

Machinery Account	Dr.	2,500	
To Profit and Loss Adjustment Account			2,500

- (b) Salaries paid Rs. 3,500 posted to wages account in the ledger. In the usual course, the rectifying entry would be:

Salaries Account	Dr.	3,500	
To Wages Account			3,500

Now as the final accounts have been prepared, no entry is required to be passed

because both the account are nominal account.

Entries for rectifying the errors prescribed in the preceding illustration in a subsequent accounting period will be as follows:

Journal Entries
(Without Narrations)

			Rs.	Rs.
(i)	Suspense Account	Dr.	180	
	To Madhav			180
(ii)	Profit and Loss Adj. Account	Dr.	2,000	
	To Suspense Account			2,000
(iii)	Mohan	Dr.	3,750	
	To Sohan			2,750
	To Suspense Account			1,000
			Rs.	Rs.
(iv)	Profit and Loss Adj. Account	Dr.	10,000	
	To Suspense Account			10,000
(v)	Profit and Loss Adj. Account	Dr.	2,500	
	To Furniture Account			2,500
(vi)	Capital Account	Dr.	14,500	
	To Profit and Loss Adjustment Account			14,500

Profit and Loss Adjustment Account

	Rs.		Rs.
(ii) To Suspense A/c	2,000	By Capital Account	
(iv) To Suspense A/c	10,000	transfer	14,500
(v) To Furniture A/c	2,500		
	<u>14,500</u>		<u>14,500</u>

Suspense Account

	Rs.		Rs.
To Difference in Trial Balance	12,820	By P&L Adjustment A/c	2,000
To Madhav	180	By Mohan	1,000
		By P&L Adjustment A/c	10,000
	<u>13,000</u>		<u>13,000</u>

Illustration 4

Pass journal entries to rectify the following errors assuming the existence of the necessary Suspense Account:

- (i) Goods bought from Mukesh amounting to Rs. 5,500 was posted to the credit of his account as Rs. 5,000.
- (ii) Sales book was overcast by Rs. 10,000.
- (iii) While carrying forward the total of one page of the Purchases Book to the next, the amount of Rs. 12,350 was written as Rs. 13,250.

- (iv) Cartage Rs. 780 paid on machinery newly acquired was debited to carriage inward account.
- (v) Purchases return to Shivalker Bros. Rs. 3,100 were not recorded in purchases returns book but the account of Shivalker Bros. was duly debited for the amount.
- (vi) Drawings of goods costing 300 were not recorded in the books of account.
- (vii) Whitewashing expenses, Rs. 670 were posted from cash book to the nominal account as Rs. 760.

Also prepare Suspense Account starting it with debit balance of Rs. 320. Have you any comments to offer on Suspense Account?

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Dr. Amount</i>	<i>Cr. Amount</i>
			<i>Rs.</i>	<i>Rs.</i>
	(i) Suspense Account Dr. To Mukesh (For rectification of short credit to Mukesh)		500	500
<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Dr. Amount</i>	<i>Cr. Amount</i>
			<i>Rs.</i>	<i>Rs.</i>
	(ii) Sales Account Dr. To Suspense Account (For rectification of wrong total of Sales Book)		10,000	10,000
	(iii) Suspense Account Dr. To Purchases Account (For rectification of wrong carry forward of total from one page to another in the Purchases Book)		900	900
	(iv) Machinery Account Dr. To Carriage Inwards A/c (For rectification of wrong debit to carriage inwards for cartage paid on newly acquired machinery)		780	780
	(v) Suspense Account Dr. To Purchases Returns Account (For rectification of omission of credit to Purchases Returns Account for goods returned to Shivalkar Bros.)		3,100	3,100
	(vi) Drawings Account Dr. To Purchases Account (For rectification of omission of drawings of goods costing Rs. 300 by the proprietor)		300	300
	(vii) Suspense Account Dr. To Whitewashing Account (For rectification of excess debit to whitewashing account)		90	90

LEDGER

Suspense Account

	Rs.		Rs.
To Balance b/d	320	(ii) By Sales Account	10,000
(i) To Mukesh	500		
(iii) To Purchase Account	900		
(v) To Purchases Returns	3,100		
(vii) To Whitewashing A/c	90		
To Balance c/d	<u>5,090</u>		
	<u>10,000</u>		<u>10,000</u>

Comment: As suspense account still shows a balance, it means all errors have not yet been rectified.

Illustration 5

Rectify the following errors by passing necessary journal entries:

- (i) Goods purchased for proprietor's use for Rs. 2,500 was debited to purchases account;
- (ii) Rs. 2,750 received from Hari Chand was debited to his account;
- (iii) Returns inward book was short totalled by Rs. 650.
- (iv) Interest on deposit received Rs. 500 had been debited in the cash account, but had not been credited to interest account.
- (v) Rs. 2,000 being purchases returned were posted to the debit of purchases account.
- (vi) Interest on overdraft Rs. 1,200 was not posted to the ledger from the cash book.
- (vii) A duplicate invoice for the purchase of machinery costing Rs. 10,000 was erroneously passed again and entered into the books.

Solution:

Rectifying Journal Entries

Particulars	Dr. (Rs.)	Cr. (Rs.)
(1)	(2)	(3)
(i) Drawings A/c Dr.	2,500	
To Purchases A/c		2,500
(Being goods purchased for personal use was wrongly debited to purchases account, now rectified)		
(ii) Suspense A/c (2,750 X 2) Dr.	5,500	
To Hari Chand		5,500
(Being cash received from Hari Chand of Rs. 2,750 was wrongly debited to his account, now rectified)		
(iii) Returns Inward A/c Dr.	650	
To Suspense A/c		650
(Being returns inward book was under cast by Rs. 650, now rectified)		
(iv) Suspense A/c Dr.	500	
To Interest Received A/c		500
(Being interest received had not been credited, now rectified)		
(1)	(2)	(3)

(v)	Suspense A/c	Dr.	4,000	
	To Purchases A/c			2,000
	To Purchases Returns A/c			2,000
	(Being purchases returns wrongly debited to purchases account, now rectified)			
(vi)	Interest A/c	Dr.	1,200	
	To Suspense A/c			1,200
	(Being interest on overdraft was not posted to the ledger from cash book, now rectified)			
(vii)	Supplier's A/c	Dr.	10,000	
	To Machinery A/c			10,000
	(Being duplicate invoice for purchase of machinery recorded in books twice, now reversed)			

Illustration 6

The trial balance of M. Mukherjee did not tally as on 31.3.2007. The following errors were detected afterwards. Pass the necessary journal entries to rectify the errors and find out the difference in trial balance.

- (i) Rs. 600 received from Mathur on 31.3.2007 was entered in the cash book on 2.4.2007.
- (ii) Returns inward book was undercast by Rs. 300.
- (iii) The purchase of typewriter for Rs. 5,000 was entered in the purchase day book.
- (iv) Wages of workmen engaged in construction of building amounting Rs. 500 were debited to wages account.
- (v) A purchase of Rs. 671 had been posted to the debit of supplier's account as Rs. 617.
- (vi) Goods amounting to Rs. 1,000 had been returned by Raju and were taken into stock, but no entry was passed for the transaction.
- (vii) Rs. 14,000 paid for purchase of T.V. for proprietors own use had been charged to miscellaneous expense account.
- (viii) A sale of Rs. 600 to Sethi was credited to his account with Rs. 60.
- (ix) A sale of Rs. 2,000 has been passed through purchase journal.
- (x) Rs. 75 paid for repairs to furniture had been entered in the total column of petty cash book, but not entered in the appropriate analysis column, the total of which has been posted.

Solution:

Rectifying Journal Entries

			<i>Dr.</i> <i>(Rs.)</i>	<i>Cr.</i> <i>(Rs.)</i>
(i)	Cash A/c	Dr.	600	
	To Mathur			600
	(Being cash received was not entered in the cash book, now rectified)			
(ii)	Returns Inward A/c	Dr.	300	
	To Suspense A/c			300

(Being returns inward book was undercast by Rs. 300, now rectified)

(iii)	Typewriter A/c To Purchase A/c (Being typewriter purchased was wrongly passed through purchase day book, now rectified)	Dr.	5,000	5,000
(iv)	Building A/c To Wages A/c (Being wages paid for construction of building was wrongly debited to wages account, now rectified)	Dr.	500	500
(v)	Suspense A/c To Supplier's A/c (Rs. 671 + Rs. 617) (Being purchase of Rs. 671 from supplier wrongly debited to his account by Rs. 617, now rectified)	Dr.	1,288	1,288
(vi)	Returns Inward A/c To Raju (Being goods returned by Raju had not been entered in the books of account now rectified)	Dr.	1,000	1,000
(vii)	Drawings A/c To Miscellaneous Expenses A/c (Being purchase of T.V. for owner had been charged to miscellaneous expenses account, now rectified)	Dr.	14,000	14,000
(viii)	Sethi (600 + 60) To Suspense A/c (Being goods of Rs. 600 sold to Sethi was wrongly credited to his account for Rs. 60, now rectified)	Dr.	660	660
			Rs.	Rs.
(ix)	Suspense A/c To Purchases A/c To Sales A/c (Being a sale of Rs. 2,000 had been wrongly passed through purchase journal, now rectified)	Dr.	4,000	2,000 2,000
(x)	Repairs to Furniture Ae/c To Suspense A/c (Being repairs for furniture had not been posted in the general ledger from petty cash book, now rectified)	Dr.	75	75

Dr.		Suspense A/c		Cr.
<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>	
To Supplier's A/c	1,288	By Returns Inward A/c	300	
To Purchases A/c	2,000	By Sethi	660	
To Sales A/c	2,000	By Repairs to Furniture A/c	75	
		By Balance c/d	<u>4,253</u>	

11. ASCERTAINMENT OF CORRECT PROFIT

If in an accounting period, errors affecting nominal accounts take place and they are not detected and rectified before the close of the books of accounts for the period concerned, the profit as revealed by the Profit and Loss Account for the period will be incorrect. The correct profit for the period can be ascertained in the next accounting period after all such errors have been detected and rectified and if the Profit and Loss Adjustments Account reveals a profit, it should be added to the profit, as revealed by the Profit and Loss Account of the previous period to know the correct profit for the previous period. On the other hand, if Profit and Loss Adjustment Account shows a loss, it would be deducted from the profit of the previous accounting period.

Illustration 7

While closing his books of account, Om Prakash finds that the Trial Balance on that date, i.e. 31st March, 2007 is out by Rs. 907 excess debit. He places the difference in a newly opened Suspense Account and prepares his final accounts which reveal a profit of Rs. 14,780 for the year ended 31st March, 2007.

In April 2007, the following errors were detected in the accounts for 2006-07;

- (i) Purchases book was undercast by Rs. 1,000.
- (ii) Cash received from Jamna Das Rs. 687 was posted to the debit of Janki Das as Rs. 678.
- (iii) Discount received Rs. 7,630 and discount allowed Rs. 6,873 were not posted to the ledger.
- (iv) Schedule of debtors was totalled Rs. 16,280 instead of Rs. 16,380. Om Prakash maintains a provision for bad debts @ 5%.
- (v) Bank charges and interest, Rs. 115 remained unposted to the debit side of the nominal account.
- (vi) Depreciation on furniture Rs. 970 was wrongly recorded as Rs. 790.

Pass journal entries to rectify the above mentioned errors, prepare Suspense Account and Profit and Loss Account and ascertain the correct amount of profit for the year ending 31st March, 2007.

Solution:

Journal

Date	Particulars	LF	Dr. Amount	Cr. Amount
			Rs.	Rs.
(i)	Profit and Loss Adjustment A/c To Suspense Account (Being rectification of error caused by undercasting of Purchases Book for 2006-07 by Rs. 1,000)	Dr.	1,000	1,000
(ii)	Suspense Account To Jamna Dass To Janki Dass (Being rectification of wrong debit of Rs. 678 to Janki Das and omission to credit of Rs. 687 to Jamna Das, in 2006-07 books)	Dr.	1,365	687 678
(iii)	Suspense Account To Profit and Loss Account	Dr.	757	757

(Being rectification of omission of posting of discount received Rs. 7,630 and discount allowed Rs. 6,873 in 2006-07)

(iv)	Sundry Debtors A/c	Dr.	100	
	Profit and Loss Adjustment A/c	Dr.	5	
	To Suspense Account			100
	To Provision for Bad Debts			5

(Being rectification of schedule of debtors and also rectification of Provision for bad debts account due to wrong basis on which the amount of bad debts was calculated in 2006-07)

			Rs.	Rs.
(v)	Profit and Loss Adjustment A/c	Dr.	115	
	To Suspense Account			115
	(Rectification of omission of posting to bank charges and interest)			
(vi)	Profit and Loss Adjustment A/c	Dr.	180	
	To Furniture Account			180
	(Being rectification of wrong entry for depreciation on furniture)			

Ledger Accounts						
Dr.	Suspense Account				Cr.	
2007		Rs.	2007		Rs.	
March 31	To Balance c/d	907	March 31	By Difference in Trial Balance b/d	907	
2007			2007			
April 1			April 1			
	(ii) " Jamna Das	687		By Balance b/d	907	
	" Janki Das	678		(i) By P & L Adj. A/c	1,000	
	(iii) " P & L Adjustment	757		(iv) By Sundry Debtors	100	
				(v) By P & L Adj. A/c	115	
		<u>2,122</u>			<u>2,122</u>	

Profit and Loss Adjustment Account					
		Rs.			Rs.
(i)	To Suspense Account	1,000			
(iv)	" Provision for Bad Debts	5	(iii)	By Suspense Account	757
(v)	" Suspense Account	115		By Loss transferred to	
(vi)	" Furniture Account	180		Capital A/c	543
		<u>1,300</u>			<u>1,300</u>

Actual profit for the year ended 31st March, 2007 = Rs. 14,780 – Rs. 543 = Rs.14,237 (Ans.).

Illustration 8

The books of account of Bipin Lal for the year ended 31st March, 2007, were closed with difference in the trial balance carried forward. Subsequently the following errors were detected.

- (i) Rs. 1,500 being the total of discount column on the credit side of the cash book was not

posted in general ledger.

- (ii) Closing stock was overstated by Rs. 9,000 being casting error in the schedule of inventory.
- (iii) Returns outward book was undercast by Rs. 150.
- (iv) A credit sale of Rs. 870 was wrongly posted as 780 to the customer's account in the sales ledger.
- (v) Rs. 6,000 being the cost of purchase of office furniture was entered in the purchase book.

Pass rectification entries, prepare suspense account, and find the effect of correction on profit as on 31st March, 2007.

Solution:

Rectification Entries

		<i>Dr.</i> (Rs.)	<i>Cr.</i> (Rs.)
(i)	Suspense A/c To Profit and Loss Adjustment A/c (Being discount received was not posted from cash book to ledger, now rectified)	Dr. 1,500	1,500
(ii)	Profit and Loss Adjustment A/c To Stock in Trade (Being closing stock was overcast by Rs. 9,000, now rectified)	Dr. 9,000	9,000
(iii)	Suspense A/c To Profit and Loss Adjustment A/c (Being returns outwards undercast, rectified)	Dr. 150	150
(iv)	Customers' A/c To Suspense A/c (Being credit sale of Rs. 870 was wrongly posted as 780, to the customer's account, now rectified)	Dr. 90	90
(v)	Office Furniture A/c To Profit and Loss Adjustment A/c (Being purchase of office furniture was wrongly entered in purchase account, now rectified)	Dr. 6,000	6,000

Suspense Account

<i>Dr.</i>		<i>Cr.</i>	
<i>Particulars</i>	<i>Amount</i> (Rs.)	<i>Particulars</i>	<i>Amount</i> (Rs.)
To Profit and Loss Adjustment A/c	1,500	By Balance b/d (Balancing figure)	1,560
To Profit and Loss Adjustment A/c	150	By Customer's A/c	90
	<u>1,650</u>		<u>1,650</u>

Profit and Loss Adjustment Account

<i>Particulars</i>	<i>Amount</i> (Rs.)	<i>Particulars</i>	<i>Amount</i> (Rs.)
--------------------	------------------------	--------------------	------------------------

To Stock in Trade	9,000	By Suspense A/c	1,500
		By Suspense A/c	150
		By Office furniture A/c	6,000
		By Loss transferred to Capital A/c	<u>1,350</u>
	<u>9,000</u>		<u>9,000</u>

Note: Effect of correct profit as on 31st March, 2007. Profit will be reduced by Rs. 1,350 subject to depreciation on furniture of Rs. 6,000.

Illustration 9

On 31st March 2007, an accountant of a sole proprietorship concern could not agree his trial balance. He put the difference in a newly opened suspense account and closed the books of account for the year. In the subsequent accounting year, the following errors in the books for the year 2006-07 were located:

- Rs. 8,000 paid for purchase of office furniture was posted to the purchases account.
- The sales book was overcast by Rs. 100.
- Wages paid for installation of machinery, Rs. 2,750 had been debited to wages account as Rs. 5,250
- A cheque for Rs. 7,330 was received from Rao after allowing him a discount of Rs. 70. It was endorsed in favour of Sen in full settlement of Rs. 7,500. The cheque was dishonoured, but no entry for dishonour was passed in the books.

Pass journal entries to rectify the above-mentioned errors. Also prepare the suspense account and profit and loss account assuming that all the errors have been located.

Solution :

Rectifying Journal Entries

<i>Particulars</i>		<i>Dr. (Rs)</i>	<i>Cr. (Rs.)</i>
(i) Office Furniture A/c	Dr.	8,000	
To Profit & Loss Adjustment A/c			8,000
(Being the cost of office furniture purchased wrongly debited to purchases account, now rectified)			
(ii) Profit & Loss Adjustment A/c	Dr.	100	
To Suspense A/c			100
(Being rectification of error caused by over casting of sales books by Rs.100)			
<i>Particulars</i>		<i>Dr. (Rs)</i>	<i>Cr. (Rs.)</i>
(iii) Machinery A/c	Dr.	2,750	
Suspense A/c	Dr.	2,500	
To Profit & Loss Adjustment A/c			5,250
(Wages Rs. 2,750 paid for the erection of machinery debited to wages account as Rs. 5,250, error now rectified)			
(iv) Rao (7,330 + 70)	Dr.	7,400	
Profit & Loss Adjustment A/c	Dr.	100	
To Sen			7,500
(Being cheque received from Rao for			

Rs. 7,330 after allowing Rs. 70 discount and endorsed to Sen against Rs. 7,500 dishonoured; no entry made earlier, error now rectified)

Suspense A/c			
Dr.			Cr.
Particulars	Rs.	Particulars	Rs.
To Profit & Loss Adjustment A/c	2,500	By Balance b/d (difference in Trial Balance—balancing figure)	2,400
		By Profit & Loss Adjustment A/c	100
	<u>2,500</u>		<u>2,500</u>

Profit & Loss Adjustment A/c			
Particulars	Rs.	Particulars	Rs.
To Suspense A/c	100	By Office Furniture A/c	8,000
To Sen	100	By Machinery A/c	2,750
To Capital A/c (Transfer of profit)	<u>13,050</u>	By Suspense A/c	<u>2,500</u>
	<u>13,250</u>		<u>13,250</u>

SELF-TEST QUESTIONS

- (a) Classify the following errors:

 - Credit sale of Rs. 1,500 to P was correctly recorded but not posted to P's Account.
 - Purchases book was undercast by Rs. 100.
 - Cash paid to Brij Behari, Rs. 500 was debited to Bankey Behari as Rs. 5,000.
 - Purchase of furniture Rs. 3,000 was recorded in Purchases Book.
 - Whitewashing charges Rs. 500 were debited to Buildings Account.

[Ans. Errors of Omission = (i)
Errors of Commission = (ii), (iii)
Errors of Principle = (iv), (v)]

(b) Which of the above mentioned errors will not affect the trial balance.
[Ans. (iv) and (v)]

(c) What will be effect of the above mentioned errors on the profits for the year?
(Increased by Rs. 2,400)
- Distinguish between:

Error of commission and error of principle.

Error of omission and error of commission.
- On 31st March 2007 the accountant of a firm, while preparing the final accounts for the year, finds that the trial balance is out by Rs. 1,000 excess credit. He places the amount in Suspense Account. In May 2007, the under mentioned errors are discovered:

 - The opening balance of furniture and fittings account for 2006-07 was written as Rs. 6,700 instead of Rs. 7,600. The firm depreciates furniture and fittings @ 10% p.a. on written down value basis.

- (ii) Sales Book for February 2007 was found overcast by Rs.100.
- (iii) A sum of Rs. 575 was received from I.N. Chakarvaty but the amount was wrongly credited to I.N. Chaturvedy.
- (iv) Cartage amounting to Rs. 125 paid in respect of new machinery purchased on 29th March was debited to carriage inwards account.
- (v) Goods invoiced at Rs. 130 were returned by Neelam Stores but by mistake an entry was passed in Returns Outwards Book.

Pass journal entries necessary to rectify the errors without affecting the profit for 2007-08. Also show suspense Account.

4. How would you rectify the following errors:

- (i) A sale of goods of the value of Rs. 2,500 to R. Roberts has been wrongly debited to Robertson & Co.
- (ii) A purchase of Rs. 1,500 from S. Narayan instead of being credited to him from the Invoice Book, has been wrongly debited to him.
- (iii) Cash Rs. 750 received from P.Basu and entered on the receipt side of the cash book has not been posted.
- (iv) A payment of Rs. 250 made to J. Jones for cash purchase of goods from him stands debited to his account.
- (v) A payment of Rs. 3,000 in respect of salary has been posted twice to salaries account.
- (vi) An amount of Rs. 4,500 drawn by the proprietor for his personal use stands debited to general expenses account.
- (vii) The total of the discount column on the debit side of the cash book for the month of March has been added short by Rs. 200.
- (viii) Rs. 400 relating to purchase of office stationery has been wrongly debited to the personal account of the proprietor.
- (ix) A credit purchase of Rs. 750 from Ramdas & Co. stands wrongly credited to Ramji & Co.

5. After getting an agreed Trial Balance, the account of M/s Senco Brother drafted the Trading and Profit Loss A/c and the Balance Sheet. The following errors were then detected by the auditors:

- (a) Rs. 2,500 received from the insurance company in full payment of claim for loss of stock in transit was deposited by the proprietor into his private bank account and was not recorded in the business books.
- (b) Goods purchased for Rs. 2,000 were included in stock, but the invoice was not entered in the books for the period under review.
- (c) There are compensating errors in the books i.e. (i) a payment of Rs. 300 as commission to a sales agent had not been posted from the cash book; (ii) dividends received were undercast by Rs. 100; (iii) purchases amounting to Rs. 190 were not posted to the account of the supplier from purchases journal and (iv) debit side of a customer's account in the sales ledger was overcast by Rs. 10.
- (d) Goods sold for Rs. 500 were returned by a customer, but no record of this return was made in the books although the returned goods were included in the stock at their cost price Rs. 380.

Show the journal entries and effect of these errors and summarise the alterations necessary in the originally drafted statement of accounts.

6. A merchant, while balancing his books of account, finds that the trial balance shows Rs. 3,765 excess credit. Being required to prepare the final accounts, he places the difference to a newly opened suspense account, which he carries forward. In the next accounting year, he locates the following errors:
- (i) A sale for Rs. 4,000 has been passed through the purchases book. The customer's account has, however, been correctly debited.
 - (ii) A sum of Rs. 896 paid to Dwarka Prasad has been credited to Durga Prasad as Rs. 869.
 - (iii) Salary Rs. 1,500 paid to a peon has been debited to the peon's personal account.
 - (iv) Schedule of debtors has been totalled Rs. 66,560 instead of Rs. 76,560. A provision for bad debts @ 5% of the debtors has been created.

Draft journal entries necessary for rectifying the above-mentioned errors.

Prepare the suspense account and show the ultimate effect of the errors on the last year's profit by preparing profit and loss adjustment account.

Suggested Readings :

- (1) *S.N. Maheshwari* — Financial Accounting
 - (2) *J.R. Monga* — Advanced Financial Accounting
 - (3) *R.L. Gupta and V.K. Gupta* — Financial Accounting
 - (4) *S.P. Jain and K.L. Narang* — Financial Accounting
 - (5) *Ashok Sehgal and Deepak Sehgal* — Fundamentals of Financial Accounting
-

STUDY V

FINAL ACCOUNTS OF NON – CORPORATE ENTITIES

1. CAPITAL AND REVENUE ITEMS

The main purpose of accounting is to ascertain the true results of the business in terms of profit and loss during a particular accounting period. The profit or loss of a business can be ascertained by matching business revenues against the cost of the same period. The emphasis is clearly on the same period. Therefore, a clear understanding between capital and revenue (expenditures and receipts) is necessary for the correct ascertainment of profit or loss. It may be noted that revenue items are included only in income statement or profit or loss account and capital items form part of balance sheet figures. Let us examine the features of capital and revenue items in the accounting parlance.

2. CAPITAL AND REVENUE EXPENDITURES

Before the preparation of final accounts, it is essential to understand clearly the distinction between the capital and revenue expenditures. Capital expenditure is that expenditure which results in acquisition of an asset or which results in an increase in the earning capacity of a business. Another test of a capital expenditure is that the benefit of such expenditure lasts for a long period of time. Obvious examples of capital expenditures are money paid for land, buildings, machinery, furniture, patents, etc.

All these assets stay in business and are used again and again. Other examples are money paid for goodwill (the right to use the established name of an outgoing firm) since it will attract the old firm's customers and thus will result in higher sales and profits; money spent to reduce working expenses, for example, conversion of hand driven machinery to power-driven machinery and expenditure enabling a firm to produce a large quantity of goods. Expenditure which does not result increase in capacity or in reduction of day to day expenses is not capital expenditure, unless there is a tangible asset to show for it. All sums spent up to the point an asset ready for use should also be treated as capital expenditure. Examples are: fees paid to lawyer for drawing a purchase deed of land, overhauling expenses of second hand machinery, cartage paid for bringing machinery to the factory from supplier's premises and money spent to install a machinery; even interest on loans taken to acquire fixed assets but only for the period before the asset becomes operational.

Expenses whose benefit expires within the year of expenditure and which are incurred to maintain the earning capacity of existing assets are termed as revenue expenditure. Amounts paid for wages, salary, carriage of goods, repairs, rent and interest, etc., are items of revenue expenditure. Depreciation on fixed assets is also a revenue expenditure. To the extent the materials are used up, they will be revenue expenditure. Similarly, cost of goods sold is revenue expenditure. Costs incurred to acquire an asset are capital but costs incurred to keep them in working condition or to defend their ownership are revenue. Fee paid to a lawyer for checking whether all the papers are in order before land is purchased is capital expenditure. But if later a suit is filed against the purchaser, the legal costs will be of revenue type. The following are the points of distinction between capital expenditure and revenue expenditure:

- (i) Capital expenditure is incurred in acquiring or improving permanent assets which are not meant for resale. But revenue expenditure is a routine expenditure incurred in the normal course of business and includes cost of sales as also the upkeep of fixed assets etc.
- (ii) Capital expenditure seeks to improve the earning capacity of the business whereas revenue expenditure purposes to maintain the earning capacity of the business.
- (iii) Capital expenditure is normally a non-recurring outlay but revenue expenditure is usually a recurring item.
- (iv) Capital expenditure produces benefits over several years. Hence only a small part is charged to income statement as depreciation and the rest appears in the balance sheet. But revenue expenditure is consumed within an accounting year and the entire amount is charged to the (current year's) income statement. Hence it does not appear in the balance sheet. Deferred revenue expenditure is however an exception to this rule.

3. DEFERRED REVENUE EXPENDITURE

There are certain expenses which may be in the nature of revenue but their benefit may not be consumed in the year in which such expenditure has incurred; rather the benefit may extend over a number of years. All such expenditures which are basically in the nature of revenue expenditure, e.g, heavy advertising expenditure incurred in introducing a new line or developing a new market. Charges of these expenses are deferred because such expenses benefit more than

one accounting period. Moreover the profits of a particular year should not be unduly affected. The matching principle demands this. The basis of charge should usually be proportionate to the benefit consumed/reaped.

The practice which varies considerably in detail is to write off the amount over the period of years in which the benefit is expected to accrue say 3 to 5 years. If the expenditure can be earmarked as being in respect of a specified object, the expenditure should be written off during the life of that object, e.g. heavy accidental losses, such as losses arising from a fire or an earthquake; the loss may be spread over a few years. The deferred revenue expenditure not yet written off is shown on the assets side of the balance sheet.

Thus, deferred revenue expenditure is revenue in character but –

- (i) the benefit of which is not exhausted in the same year, or
- (ii) is applicable either wholly or in part of the future years, or
- (iii) is accidental with heavy amount and it is not prudent to charge against the profit of one year.

The deferred revenue expenditure may be classified into the following four categories:

- (i) Expenditure wholly paid in advance, where no service has yet been performed, necessitating it being carried forward, e.g. office rent, telephone rent etc. paid in advance.
- (ii) Expenditure partly paid in advance, where a portion of the benefit has been derived within the accounting period, the balance yet being unused and therefore, shown in the balance sheet as an asset e.g. special advertising expenditure for a new product.
- (iii) Expenditure in respect of service rendered which for any sound reason is considered as an asset or more properly not considered to be allocable to the accounting period e.g. cost of experiments, discount on issue of debentures etc.
- (iv) Amounts representing loss of an exceptional nature e.g. property confiscated in a foreign country, loss on uninsured assets etc.

4. COMPARISON BETWEEN CAPITAL EXPENDITURE AND DEFERRED REVENUE EXPENDITURE

The main feature of capital expenditure is that results in a benefit which will accrue to the business enterprise for a long time, say 10 or 15 years. Deferred revenue expenditure also results in a benefit which will accrue in future period but generally for 3 to 5 years.

The capital expenditure or the resulting asset is usually capable of being reconverted into cash though may be at a loss. This is not possible in the case of deferred revenue expenditure. At times, heavy loss such as loss due to earthquake is treated as deferred revenue expenditure in the sense that they are written off over a period of 3 to 5 years. Such a loss cannot be treated as capital expenditure.

5. CAPITAL RECEIPTS AND REVENUE RECEIPTS

Capital receipts comprise of payments or contributions into the business by the proprietor, partners or other shareholders towards the capital of the firm and also any sum received from debentureholders, any loans and the proceeds of sale of any fixed assets of a business enterprise.

Revenue receipts is the outcome of a firm's activity in the accounting period, part of its rewards for offering goods or services to the public e.g. sales, commission, fees received for services, interest on investment, etc. Revenue receipts must be set off against the revenue expenses in order to calculate the profit or loss of the business in an accounting period. Capital receipts and expenditure have no bearing on the profit or loss for the accounting period. The distinction between capital receipts and revenue receipts can be drawn as follows:

<i>Capital Receipts</i>	<i>Revenue Receipts</i>
(1) Amount realised by the sale of fixed assets or by issue of shares or debentures is capital receipts.	Amount realised by sale of goods or rendering services is always revenue receipt.
(2) A receipt in substitution of a source of income is a capital receipt.	A receipt in substitution of an income is a revenue receipt.
(3) Amount received for surrender of certain rights under an agreement is a capital receipt, because a capital asset is being given up in the form of these rights.	Amount received as compensation under an agreement for the loss of future profits is a revenue receipt.
(4) Instead of lump sum payment if the payment is received in instalments it is a capital receipt.	If an income is received in lump sum it is a revenue receipt.
(5) Amount realised from the sale of capital assets or investment is capital receipt.	Amount realised from the sale of assets kept for sale is revenue receipt.

6. CAPITAL PROFITS AND REVENUE PROFITS

While preparing the final accounts distinction has to be made between capital profits and revenue profits. Revenue profits are earned in the ordinary course of business. They appear in the profit and loss account and are available for distribution as profit, or for creating reserves and funds, or for being used in the business. However, capital profits, are those which are earned as a result of selling some fixed assets, or in connection with raising capital for the firm. For instance, a building purchased for Rs. 1,50,000 was subsequently sold for Rs. 1,75,000, this Rs. 25,000 will be profit of capital nature. Similarly when a company issues its shares of the face value Rs. 100 for Rs. 105 each, it is said that shares have been issued at premium which is capital profit. Capital profits are either capitalised i.e. transferred to capital account or transferred to capital reserve account which may be utilised for meeting capital losses.

7. CAPITAL LOSSES AND REVENUE LOSSES

Revenue losses are the losses which arise during the normal course of business whereas capital losses are those which occur when selling fixed assets or raising share capital. If a building purchased for Rs. 50,000 is sold for Rs. 45,000, there will be capital loss of Rs. 5,000. Similarly when shares of the face value of Rs. 100 are issued at Rs. 95 i.e. at a discount of Rs. 5, the amount of discount will be capital loss.

Treatment of capital losses is not different from that of capital profits. Just as capital profits are not shown in profit and loss account, similarly capital losses are not shown in the profit and loss account. They are shown in the balance sheet on the asset side. As and when capital profit arise, capital losses are gradually written off against it. If however, capital losses are huge, the common practice is to spread them over a number of years and charge a part thereof to profit and loss account, to each such year. But if they are negligible, they are debited to profit and loss account of the year in which they occur.

Illustration 1 :

State which of the following expenditures are capital, revenue and deferred revenue expenditures and capital loss :

- (i) Cost of overhauling and painting a second hand truck newly purchased.
- (ii) Cost of making more exits in a cinema hall under order of the Government.
- (iii) Rs. 25,000 were spent on air conditioning the office of the General Manager.
- (iv) An old machine which stood in the books at Rs. 15,000 was sold for Rs. 13,000.
- (v) Rs. 2,000 were paid as municipal tax in connection with a building which was purchased last year for Rs. 2,00,000.
- (vi) Rs. 30,000 were spent on heavy advertising in connection with the introduction of a new product.
- (vii) Rs. 500 was paid out in connection with carriage on goods purchased.
- (viii) A temporary room constructed for Rs. 25,000 for storing raw material for the construction of a big building.
- (ix) Rs. 50,000 was spent on putting up a gallery in a theatre hall.
- (x) Freight and cartage amounting to Rs. 4,000 were paid on purchase of a new plant and a sum of Rs. 2,000 was spent as erection charges of that plant.

Solution :

- (i) When a second hand machine is purchased, all expenditure incurred in the beginning to make it fit for working is treated as capital expenditure. The value of the machine is increased by the amount spent. Therefore the cost of overhauling and painting the truck will be treated as capital expenditure.
- (ii) Making more exits in a cinema hall does not increase the capacity of the hall and therefore, it should be treated as revenue expenditure.
- (iii) The sum of Rs. 25,000 spent on air conditioning the office of General Manager is capital expenditure because it represents a fixed asset. Moreover the effect of air conditioning will be available for several years to come, and it can possibly be disposed of, if desired, at a future date, when it will fetch some return.
- (iv) The old machine costing Rs. 15,000 was sold for Rs. 13,000 only, and the loss of Rs. 2,000 is clearly capital loss.
- (v) Rs. 2,000 paid by way of municipal tax on a building purchased is an item of revenue nature. It is an expenditure of routine nature, which was necessary for using the building.
- (vi) Since the benefit of Rs. 30,000 spent on advertising will occur for several years, it is of capital nature. It may be treated as deferred revenue expenditure and be written off against the profit and loss account of a number of years.
- (vii) The expenditure of Rs. 500 incurred on carriage on goods purchased is of revenue expenditure because the goods are meant for resale.
- (viii) Rs. 25,000 spent on construction of temporary room should be treated as capital expenditure because it was necessary for the construction of the main building. The cost of the room will be added to the cost of the building.
- (ix) When a new gallery is put up, it will increase the number of seats (capacity) of the hall. Therefore, this cost of Rs. 50,000 should be treated as capital expenditure.
- (x) The expenditure incurred by way of freight and cartage amounting to Rs. 4,000 and the erection charges of Rs. 2,000 are both of capital nature. The former has been incurred in connection with the receipt of a capital asset while the latter has been incurred for erecting it so that it may be used for business purposes.

Illustration 2 :

State whether the following expenses are capital, revenue or deferred revenue expenditure:

- (i) A Ltd. spent Rs. 2,00,000 for overhauling the machinery which improved the capacity utilisation and saved running expenditure by Rs. 15,000 p.a.
- (ii) M/s Capital Properties, property dealers, purchased ten flats @Rs. 7,00,000 each.
- (iii) A firm incurred Rs. 10,000 to retain the title of a land purchased for business in litigation with third party.
- (iv) Compensation paid to undesirable employees.
- (v) M/s Durga & Co. spent Rs. 2,50,000 for organising an Inter-school Cricket Tournament in Delhi. This was held for advertising their new school bag and other books and stationery which they want to market.
- (vi) Rs. 12,000 paid to Mahanagar Telephone Nigam Ltd. for installing telephone in the office.
- (vii) Damages paid on account of breach of contract to supply certain goods.
- (viii) Rs. 25,000 has accrued during the year on term loan obtained and utilised for the construction of factory building and purchase of machineries, however, the production has not commenced till the last date of the year.
- (ix) Imported goods worth Rs. 1,75,000 confiscated by customs authorities for non-disclosure of material facts.
- (x) Rs. 20,000 spent for the trial run of a newly installed machinery.

Solution :

- (i) Expenses for overhauling the machinery increases capacity utilisation which contributes to increase the revenue generating capacity. Also saving in revenue expenditure for more than one accounting period will accrue from this overhauling which will increase future profit. Hence, this expense is capital in nature.
- (ii) Purchase of flats in the ordinary course of business activities for stock in trade is revenue expenditure.
- (iii) Legal expenses incurred to retain the title of land are expenses for maintaining the asset. The expenses will not generate any revenue in future directly. Hence, it is revenue in nature.
- (iv) Compensation paid to retrench undesirable employees is expected to increase revenue earning capacity of the business because such undesirable employees would either waste resources or time with adverse effect on profit. The expenditure is capital in nature.
- (v) The purpose of expenses incurred for organising the Inter-School Cricket Tournament is to advertise for some new products. This advertisement has some enduring effect so far as the marketability of the new product is concerned. The expense may be treated as deferred revenue expenditure.
- (vi) The money deposited with Mahanagar Telephone Nigam Ltd. for acquiring telephone connection is treated as an asset, hence it is a capital expenditure.
- (vii) Damages paid on account of the breach of contract to supply certain goods are treated as revenue expenditure incurred in the ordinary course of the business.
- (viii) Interest accrued on term loan obtained and utilised for the construction of factory building and purchase of machinery should be treated as capital expenditure since commercial production has not started till the last date of the accounting year.
- (ix) The confiscation of imported goods by the customs authorities is a loss arisen on account of negligence and is abnormal nature. It is appropriate to write it off to profit and loss account over a period of 2 to 5 years treating it as deferred revenue expenditure.

- (x) Expenses incurred for trial run of a newly installed machinery is capital expenditure in nature.

8. FINAL ACCOUNTS

The transactions of a business for an accounting period are first recorded in journal (subsidiary books), then posted therefrom to the ledger and their accuracy is tested with the help of a trial balance. The last stage in the accounting process is the preparation of a summary of the accounts with a view to determine - (i) its net profit from the trading activities in terms of profit made or loss incurred for a given period, and (ii) its financial position in terms of assets and liabilities as on the last date of the given period.

For the purpose of determining the profit or loss, a statement known as Trading and Profit and Loss Account (income statement) is prepared which incorporates all items of expenses and losses and all incomes and gains occurring during the accounting period. This account is divided into two parts - (i) Trading Account which shows the results of trading (gross profit), and (ii) Profit and Loss Account which shows the final figure of net profit or net loss. Of course this is one account. In order to show the financial position on the last date of the accounting period, another statement known as Balance Sheet (position statement) is prepared which consists of all assets, liabilities and capital of the business. These two statements are collectively known as Final Accounts or Financial Statements, as they are the end products of the financial accounting process. Final accounts are the means of communication of the financial position and performance of a business to the various user groups.

Final accounts are prepared from the account balances appearing in the trial balance. In order to accommodate an item from the trial balance to the final accounts, the following procedure may be followed.

- (i) *Debit account balances* : Balances appearing on the debit column of the trial balance may represent - (a) assets, and (b) expenses and losses. Assets are shown on the right hand side of the balance sheet while expenses and losses are debited either to the Trading Account or to the Profit and Loss Account, depending upon the nature of expenditure or loss.
- (ii) *Credit account balances* : Credit terms in the trial balance represent - (a) capital, liabilities, provisions and reserves. These items are entered on the left hand side of the balance sheet. In cases, some items are shown as deductions from assets shown on the right hand side of the balance sheet (e.g. provision for doubtful debts, depreciation etc.); (b) incomes and gains. These are either credited to Trading Account or Profit and Loss Account.

9. MAIN PRINCIPLES OF PREPARING TRADING AND PROFIT AND LOSS ACCOUNT

The following principles must be kept in mind while preparing these accounts:

- (i) Only revenue receipts, i.e. sale proceeds and other incomes should be entered.
- (ii) Only revenue expenses together with losses should be taken into account.
- (iii) Expenses and incomes relating only to the period which the accounts are being prepared should be considered. Suitable adjustments have to be made in order to ensure that the figures relate to that period only, not to the previous period or a future period.
- (iv) All expenses and incomes relating to the concerned period should be considered even if the expense has not yet been paid in cash or the income has not yet been received in cash.
- (v) While preparing Trading and Profit and Loss Account distinction must be made between the personal expenses of the proprietor or partners and the expenses

relating to the firm. All personal expenses of the proprietor or partners must be debited to the capital or drawing accounts and must not be debited to the Trading and Profit and Loss Account.

10. TRADING ACCOUNT

Trading Account is the first part of income statement which is prepared to ascertain the gross profit or gross loss for a given accounting period. Gross profit is the difference between the selling price and the cost price of the goods sold and is a determining factor in the business. However, when the cost of goods sold is more than the selling price, the result is gross loss. Cost of goods sold consists of two elements - (a) Cost of opening stock of goods plus cost price of net purchase less cost of the closing stock of such goods at the end, and (b) all direct expenses i.e. expenses incurred on purchases of goods and bringing them into saleable condition, e.g. freight, insurance, wages, carriage inwards, octroi, etc. A specimen of Trading Account is given below.

Trading Account for the year ended.....

Dr.		Cr.	
Particulars	Rs.	Particulars	Rs.
To Opening stock		By Sales	
To Purchases		Less : Returns	
Less : Returns		By Closing stock	
To Direct expenses			
To Gross profit			
.....			

Here gross profit is the balancing figure, in case debit side exceeds the credit side, then the balance will be gross loss and that will be shown on the credit side of Trading Account as "By Gross Loss".

Usually no account is maintained to show the value of closing stock. In order to ascertain the gross profit correctly, the following entry is passed.

Stock Account	Dr.
To Trading Account	

Alternatively, the following entry can also be passed.

Stock Account	Dr.
To Purchases Account	

In this case closing stock will not be shown in Trading Account, it appears in trial balance.

In a manufacturing concern which does not prepare Manufacturing Account, Trading Account is debited with all those expenses also which are necessary to convert raw materials into finished product. Examples are purchases of raw materials, wages paid to workmen, fuel and power to propel the machines etc. Logically, depreciation on plant and machinery used for production of goods should also be debited to Trading Account like other manufacturing expenses. But traditionally it is debited to Profit and Loss Account, presumably because the amount of depreciation is determined more or less arbitrarily.

In trading account, closing stock is shown at cost price or net realisable price whichever is lower. While taking stock for the purpose of preparation of trading account, stock in hand on the last day of the accounting year should be adjusted for purchases recorded but goods not yet received, goods sold but not yet delivered and goods that may be out of business premises because of consignment, goods delivered on sale or return basis, etc.

Gross profit or gross loss revealed by Trading Account is transferred to Profit and Loss

Account.

11. PROFIT AND LOSS ACCOUNT

As stated earlier, Profit and Loss Account is prepared to calculate the net profit or loss of the business for a given accounting period. The balance of Trading Account i.e. gross profit/gross loss is transferred to the Profit and Loss Account which is the starting point of the preparation of this account. Thereafter, all those expenses and losses which have not been debited already to the Trading Account are debited to the Profit and Loss Account. Other incomes and gains if any, are credited to this account, for e.g. interest earned or commission received, etc.

The profit and loss account measures net profit by matching revenues and expenses according to the accounting principles. Net profit is the difference between total revenues and total expenses. In this connection we may remember that all the expenses, for the period are to be debited to this account, whether paid or not. If it is paid in advance (prepaid expenses) or outstanding, proper adjustments are to be made. Similarly, all incomes whether received or not, are to be credited. Incomes received in advance or accrued but not received are to be properly adjusted. The net profit thus arrived is transferred to Capital Account of the proprietor/partners. Of course, net profit increases the capital and net loss decreases the capital of the proprietor. A format of Profit and Loss Account is as follows:

Profit and Loss Account for the year ended...			
Dr.			Cr.
Particulars	Rs.	Particulars	Rs.
Management Expenses:	-	By Gross Profit b/d*	-
To Salaries (administrative)	-	Other income:	-
To Office rent, rates and taxes	-	By Discount received	-
To Printing and stationery	-	By Commission received	-
To Telephone charges	-	Non-trading income:	-
To Postage and telegrams	-	By Bank interest	-
To Insurance	-	By Rent of property let-out	-
To Audit fees	-	By Dividend from shares	-
To Legal charges	-	Abnormal gains:	-
To Electricity charges	-	By Profit on sale of machinery	-
Maintenance expenses:	-	By Profit in sale of investment	-
To Repairs and renewals	-		
To Depreciation on:			
Office equipment	-		
Office furniture	-		
Office building	-		
Particulars	Rs.	Particulars	Rs.
Selling and distribution expenses:			
To Salaries (selling staff)	-		

* Gross loss will appear on the debit side of the Profit and Loss Account at the top, as "To Gross Loss b/d"

To Advertisement	-	
To Godown rent	-	
To Carriage outwards	-	
To Bad debts	-	
To Provision for bad debts	-	
To Selling commission	-	
<i>Financial expenses:</i>		
To Bank charges	-	
To Interest on loans	-	
To Discount on bills	-	
To Discount allowed to customers	-	
<i>Abnormal losses:</i>		
To Loss on sale of machinery	-	
To Loss on sale of investment	-	
To Loss by fire	-	
*To Net Profit (transferred to Capital A/c)	-	-

*Net Loss will appear on the credit side of the Profit and Loss Account as "By Net Loss".

It may be noted that the following expenses do not appear in the Profit and Loss Account:

- (a) Domestic or household expenses of the proprietor/partners. (i.e. personal expenses).
- (b) Drawings in the form of cash or goods by the proprietor/partners.
- (c) Personal income-tax or life insurance premium paid by the firm on behalf of the proprietor/partners.

12. DIFFERENCE BETWEEN TRADING ACCOUNT AND PROFIT AND LOSS ACCOUNT

The following are the points of distinction between Trading Account and Profit and Loss Account:

<i>Trading Account</i>	<i>Profit and Loss Account</i>
(i) Trading account is prepared to calculate the gross profit (loss) for a particular period.	Profit and Loss account is prepared to arrive at the net profit (loss)
(ii) In trading account, cost of goods sold, sales and direct expenses are accounted.	In profit and loss account, indirect expenses, such as administrative expenses, selling expenses, etc, are charged against the gross profit and other revenues.
(iii) The result of trading account i.e. gross profit (loss) is transferred to profit and loss account.	The balance in profit and loss account is transferred to capital account which will be shown in the balance sheet.

13. BALANCE SHEET

Balance sheet is a statement which shows the financial position i.e. the balances of assets, liabilities and capital, of a business entity at a given date. It is prepared from the trial balance after all nominal accounts and accounts relating to goods have been closed by transferring to Trading and Profit and Loss Account. Now accounts left out are the real accounts and personal accounts. There will be some newly opened accounts as well, on account of adjustment entries. Some of these accounts may have debit balances and others have credit balances. In principle, a debit balance in a real account or personal account represents an asset of the concern/firm. Likewise a credit balance in a personal account represents a liability. Thus, these assets and liabilities are arranged in a proper way and the resultant statement is the balance sheet. On the right hand side, assets are arranged while on the left hand side, liabilities are recorded. The totals of the two sides of the balance sheet must agree because of the equation, viz. Assets = Liabilities + Capital. If there is a difference, it means that there is some mistake. The difference, if it does occur, should be placed on the deficit side as Suspense Account to make the two sides agree apparently.

The following are the nature of balance sheet:

- (i) The primary objective of the preparation of balance sheet is to ascertain the financial position of a concern. It shows (a) the nature and value of assets, (b) the nature and value of liabilities and (c) the position of capital.
- (ii) Balance sheet is always prepared on a certain date, never for a particular period.
- (iii) Balance sheet, unlike a trading and profit and loss account, is not an account. It is a statement containing information regarding assets, liabilities and capital.

14. DIFFERENCE BETWEEN TRIAL BALANCE AND BALANCE SHEET

The following are the points of distinction between trial balance and balance sheet:

<i>Trial balance</i>	<i>Balance sheet</i>
1. It is a statement of debit balances and credit balances taken from the ledger.	It is a statement of assets and liabilities
2. It is prepared to test the arithmetical accuracy of books of account.	It is prepared to ascertain the financial position of the organization on a particular date.

- | | |
|---|---|
| 3. Balances of all types of accounts i.e. personal, real, and nominal accounts are shown. | Balances of real and nominal accounts only are shown. |
| 4. It is usually prepared at the end of each month, three months, six months or year before the preparation of trading and profit and loss account. | It is usually prepared at the end of the year after the preparation of trading and profit and loss account. |
| 5. Closing stock does not appear in the trial balance. | Closing stock is shown on the assets side of the balance sheet. |
| 6. It is prepared for internal use. | It is prepared for external use, i.e. for outside parties such as, creditors, shareholders (in case of companies), government authorities, etc. |
-

15. DIFFERENCE BETWEEN PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

- (i) **Profit and loss account itself is an account whereas balance sheet is a statement of assets and liabilities.**
- (ii) Profit and loss account shows the profits earned or losses incurred for the accounting period whereas the balance sheet shows financial position of the business.
 - (iii) Profit and loss account is prepared for the accounting period whereas the balance sheet is prepared as at the last day of the accounting period.
 - (iv) The accounts that are transferred to the profit and loss account are closed and ceased to exist. But the accounts which are transferred to the balance sheet do not lose their identity and become the opening balances of the next accounting period.

16. CLASSIFICATION OF ASSETS

- (i) *Fixed Assets* are those which are acquired for long use in the business itself and not for resale. For example, plant and machinery, land and buildings, furniture and fixtures, patents and trade marks are fixed assets.
- (ii) *Current or Floating Assets* are those that are meant to be converted into cash as soon as possible. Stock of goods, amount due from customers to whom goods have been sold on credit and balance at bank are examples of current (or floating) assets.
- (iii) *Liquid Assets* are those current assets which are already in the form of cash or which can be readily converted into cash, such as Government Securities.
- (iv) *Wasting Assets* are those fixed assets which have a fixed content, like coal in a coal mine; the value goes down as the contents are taken out. When the minerals have been taken out, the mine will become useless.
- (v) *Intangible Assets* are those fixed assets which cannot be seen or touched or felt. Goodwill (the value of one's name) is an intangible assets because there is no physical form to show it. Intangible assets are not necessarily useless.
- (vi) *Fictitious Assets* are valueless assets but shown as assets in the financial statements (such as useless trade marks) or expenses treated as assets (such as expenses incurred to establish a company - preliminary expenses).

17. CLASSIFICATION OF LIABILITIES

- (i) *Fixed and Long-term Liabilities* : Fixed liabilities are those liabilities which are payable

on the termination of the business such as capital of the proprietor, whereas long-term liabilities are those which will be redeemed after a long period of time e.g. long-term loans.

- (ii) *Current liabilities* : These are liabilities which have to be redeemed in the near future, usually within a year. Trade creditors, bank loans, bills payable etc. are examples of current liabilities.
- (iii) *Contingent liabilities* : These are not actual liabilities but their becoming actual liabilities depend on the happening of certain events. If such events do not occur, no liability is incurred. Liability in respect of pending suit is a contingent liability because it is only if and when suit is lost that the liability will be incurred. Bills discounted with a bank are also contingent liability because if the acceptor fails to meet the bill on due date, the firm will become liable to the bank. Such liabilities are not shown in balance sheet, usually a foot note is appended at the balance sheet for such liability.

18. MARSHALLING OF BALANCE SHEET

The arrangements of assets and liabilities in accordance with a particular order is known as marshalling of balance sheet. The items in the balance sheet are generally marshalled in two ways- (i) Liquidity order or according to time, and (ii) Permanence order or according to purpose. In liquidity order the assets are stated in the order in which they can be easily converted into cash and the liabilities in the order in which they have to be paid off. In Permanence order, assets which are to be used permanently in the business and are not meant for sale are shown first and the assets which are most liquid are shown last in order. Similarly, liabilities may also be shown according to the permanence arrangement, i.e. capital, long term liabilities, short term liabilities etc. An arrangement of assets and liabilities under liquidity order is given below. However, in permanence order the items of assets and liabilities will be arranged in the reverse order.

Order of Liquidity

Balance Sheet as at...

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Bills payable	-	Cash in hand	-
Sundry creditors	-	Cash at bank	-
Bank overdraft	-	Bills receivable	-
Outstanding expenses	-	Investments	-
Loans on mortgages	-	Sundry debtors	-
Capital	-	Stock	-
Add : Net profit	-	Furniture and fixtures	-
	-	Plant and machinery	-
Less : Drawings	-	Land and building	-
	—	Goodwill	—
	-		-
	—		—

19. MATCHING PRINCIPLE

A fundamental principle which must be observed while preparing final accounts is that of 'matching cost and revenue'. It means that in final accounts, expenses and incomes for the full trading period whether they have been paid or received or not, must be included and no expenditure or income which does not pertain to the period for which final accounts are being prepared be included. The distinction between capital and revenue items is also made on the basis of this principle. The principle also implies that if expenses have been incurred this year but sales are to take place next year, the expenditure should also not be considered to ascertain profit for the current year. This is done by the device of work-in-progress.

20. ADJUSTMENT ENTRIES

Usually, final accounts are prepared from the balances given in the trial balance. However, at times some account balances in the trial balance do not reflect the correct 'amount' when considered in relation to accounting period. For example, payment on account of expense, say, rent, may be less or more than the actual payment that ought to have been made during the accounting period. Similar situation may arise in respect of some revenue items also, say interest on investments.

In order to ensure that the final accounts disclose the true trading results and correct balances, it is necessary that all expenses incurred whether paid or not and the whole amount of loss sustained whether ascertained or estimated should be taken into consideration. Similarly incomes and gains whether actually received or not during the accounting period should be accounted for. All this requires adjustment entries which are used to establish correct values of account balances at the end of an accounting period. Thus, adjustment entries are those entries which are passed at the end of each accounting period for the purpose of adjusting various nominal and other accounts so that true net profit or loss is indicated in profit and loss account and the balance sheet may represent a true and fair view of the financial conditions of an enterprise.

The following are the usual adjustment entries which are made while preparing the final accounts.

(i) Closing stock

The unsold stock at the end of the accounting period is termed as closing stock and the following adjustment entry is passed:

Closing Stock Account	Dr.
To Trading Account	

The stock at the end appears in trading account and in balance sheet. It becomes the opening stock for the next year and transferred to the trading account on the debit side.

Alternatively, the following entry can also be passed.

Stock Account	Dr.
To Purchases Account	

In this case, closing stock appears in the trial balance, it means that double entry has been completed in the accounting period itself by reducing the purchases, hence, it will not appear in the trading account but will appear in the balance sheet.

(ii) Accrued or outstanding expenses

Expenses which have been incurred during the year and whose benefit has derived during the year but payment in respect of which has not been made are called outstanding or accrues expenses. At the end of the year all such expenses must be brought into books, otherwise, the profit will be overstated and liability will be understated. The following journal entry is passed:

Expenses Account	Dr.
To Expenses Outstanding Account	
or	
To Accrued Expenses Account	

The outstanding expenses are shown in the debit side of the trading account or profit and loss account, as the case may be, by way of addition to the respective expenses and these are also shown on the liabilities side of balance sheet. In the beginning of the next year a reverse entry will be passed.

For example, salary for March, 2007 Rs. 1,000 has not been paid. The adjustment entry will be:

Salary Account	Dr.	Rs.	Rs.
To Outstanding Salary Account		1,000	1,000

The entry will increase the balance in salary account by Rs. 1,000 which will be transferred to profit and loss account. Outstanding salary account is a liability which will appear in balance sheet.

(iii) Unexpired or prepaid expenses

Those expenses which have been paid in advance and whose benefit will be available in future are called unexpired or prepaid expenses e.g. insurance premium, rent, etc., paid in advance. An adjustment entry is made whereby the unexpired amount is credited to the appropriate expenses account and debited to prepaid (unexpired) account as under:

Prepaid Expenses Account	Dr.
To Expenses Account	

The amount of prepaid expenses is shown as an asset in the balance sheet and is shown in the profit and loss account by way of deduction from the concerned expenses. In the beginning of the next year a reverse entry will be passed to cancel the effect of adjusting entry.

For example, fire insurance premium, Rs. 2,000 was paid for the year ending 30th June, 2007.

On 31st March, 2007 insurance policy has run only for 9 months and hence only 3/4th of the premium can be said to pertain to 2006-07: 1/4th of the premium amount, i.e. Rs. 500 will be treated as an asset. Entry will be:

		Rs.	Rs.
Unexpired Insurance Premium	Dr.	500	
To Insurance Premium Account			500

Unexpired insurance premium will appear as an asset in the balance sheet and insurance premium account will be reduced by Rs. 500.

(iv) Accrued or outstanding income

Accrued income means income which has been earned by the business during the accounting year but which has not become due and hence has not been received. But outstanding income means any income which has become due during the accounting year but has not been so far received by the firm. Though there is distinction between the two, for adjustment entry no such distinction is necessary, both the accrued income and outstanding income are added to the given income figure in the trial balance.

The following entry is passed:

Accrued Income Account	Dr.
or	
Outstanding Income Account	Dr.
To Income Account	

Obviously the adjusting entry has the effect of increasing the amount of income to be transferred to the credit of profit and loss account while the debit balance in the accrued/outstanding income account appears as an asset in the balance sheet. In the beginning of next year a reverse entry will be passed.

Example : Interest earned but not yet received, Rs. 650

The entry will be:

		Rs.	Rs.
Interest Accrued Account	Dr.	650	
To Interest Account			650

Interest accrued account will appear as an asset in balance sheet and the amount of interest account to appear on the credit side of profit and loss account will increase by Rs. 650.

(v) Unearned income or income received in advance

That portion of the revenue received in advance (unearned) at the end of the accounting period is known as unearned income or income received in advance. For example, subscription received in advance by a club, insurance premiums received in advance by the insurance company, rent received in advance, etc. Any income in advance is not actually earned and it creates an obligation to return this amount. The following adjustment entry is made at the end of the accounting year;

Income Account	Dr.
To Income Received in Advance Account	

This item is shown on the credit side of the profit and loss account by way of deduction from the income and is shown in the balance sheet on the liabilities side as 'Income received in advance'.

Example: Rent for April, 2007 Rs. 3,000 received in advance

		Rs.	Rs.
Rent Received Account	Dr.	3,000	
To Rent Received in Advance Account			3,000

The balance of rent received account to appear on credit side of profit and loss account will diminish by Rs. 3,000 and rent received in advance account will appear on liabilities side of balance sheet because service for this rent is to be rendered in the year to come.

(vi) Depreciation

Depreciation is the reduction in the value of fixed assets due to its use, wear and tear or obsolescence. When an asset is used for earning purpose, it is necessary that reduction due to its use must be charged to the profit for the year in order to show correct value in the balance sheet.

The following journal entry is passed for charging depreciation:

Depreciation Account	Dr.
To Fixed Asset Account	

The amount of depreciation is debited to the profit and loss account. Again it is shown on the asset side of the balance sheet by way of deduction from the concerned assets.

When depreciation is given in the trial balance, it means that the asset(s) has(ve) been credited with the amount of depreciation and the necessary debit to depreciation account has been made. The only entry then would be to transfer the depreciation account to profit and loss account and no adjustment entry would, therefore, be needed.

There are various methods of providing depreciation, but in questions on final accounts, it is most likely asked to be calculated at a fixed percentage of opening balance of the assets. If there are additions depreciation is provided only for that part of the year for which the new asset has been used. For example, if furniture stood at Rs. 1,00,000 on 1st April, 2006 and additional furniture was purchased for Rs. 15,000 on 1st October, 2006, total depreciation @5% per annum would amount to Rs. 5,375 calculated as under:

Depreciation on 1,00,000 @ 5% for full year	=	Rs. 5,000
Depreciation on Rs. 15,000 @ 5% for 6 months i.e., from 1st October, 2006 to 31st March, 2007		
$\frac{\text{Rs. } 15,000 \times 5 \times 6}{10 \times 12}$		375

Entry will be:		Total	<u>5,375</u>
		Rs.	Rs.
Depreciation Account	Dr.	5,375	
To Furniture Account			5,375

Depreciation account will appear on the debit side of profit and loss account and the book value of furniture will be reduced by Rs. 5,375; only the balance will appear in balance sheet.

(vii) Bad debts

Debts which cannot be recovered or become irrecoverable are called bad debts. It is a loss to the business and is brought into account by debiting bad debts account and crediting debtor's account who is not able to pay the amount. The adjustment entry is as follows:

Bad Debts Account	Dr.
To Sundry Debtors Account	

The bad debts account is debited to profit and loss account and in the balance sheet, the debtors balance is reduced by the same amount. When the amount of bad debts is given in the trial balance itself, no adjusting entry is required, it should only be transferred to profit and loss account.

(viii) Provision for bad debts

A firm may make provision at the end of the accounting year for likely bad debts which may happen during the course of the next year. This is for the simple reason that if out of credit sales made during a particular year, some sales are likely to become bad in the course of the next year, the proper course would be to charge in the same accounting year with such likely bad debts in which the sales have been made.

The following journal entry is passed for creating provision for bad debts:

Profit and Loss Account	Dr.
To Provision for Bad Debts Account	

The provision for bad debts is charged to profit and loss account and is deducted from debtors in the balance sheet. Provision for bad debts created out of profit of the current year should be carried forward to the next period. Bad debts occurring during that period would be debited to bad debts account as usual, but total debits given to this account should be transferred to provision for bad debts account. At the end of the next year suitable adjustment entry is passed for keeping the provision for bad debts at an appropriate amount to be carried forward.

If debts of 2006-07, prove to be bad in 2007-08 the loss is to be treated as one for 2006-07. But on 31st March, 2007 when final accounts are prepared, it will not be possible to know accurately, which debts will prove bad in 2007-08. Hence, only an estimate is made on the basis of past experience. If it is estimated that 6% of the debts may prove bad and on 31st March, 2007 debtors amount to Rs. 40,000, then Rs. 2,400 will be provided for future bad debts. The entry is:

		Rs.	Rs.
Profit and Loss Account	Dr.	2,400	
To Provision for Bad Debts Account			2,400

It will reduce the profit for 2006-07 by Rs. 2,400. Provision for bad debts will appear in the balance sheet as a deduction from sundry debtors on asset side although it is a separate account

showing credit balance.

In the next year, the actual amount of bad debts will be debited to provision for bad debts account which will then stand reduced. On 31st March, 2008 the amount of the provision will be brought up by an appropriate debit to profit and loss account depending on the amount of sundry debtors as at that date.

Sometimes the balance brought down from the previous year is so large that even after debiting the current year's bad debts and leaving the desired balance at the end of the year, a surplus is left. This surplus is transferred to the credit side of profit and loss account.

Details are given in the profit and loss account to show how the amount of debit or credit has been arrived at.

(ix) Provision for discount on debtors

This is a charge made against profits in order to provide for an expected loss in the form of discounts which are likely to be allowed to the debtors, for encouraging them to make prompt payments.

In order to incorporate such provision for discount on debtors, the following journal entry is made:

Profit and Loss Account	Dr.
To Provision for Discount on Debtors Account	

It may be noted that provision for discount is calculated on the amount of debtors left after deducting the provision for bad debts i.e. provision should be calculated on good debts. It is because no discount will be allowed on amounts which are not recovered and hence no provision for discount on such amount is required.

This provision is shown on the debit side of the profit and loss account and in the balance sheet it should be shown by way of deduction from sundry debtors.

For example, if 2% discount is allowed, debtors are of Rs. 10,000 and 5% provision for bad debts is required then provision for discount will be made @2% on Rs. 9,500, i.e., on Rs. 10,000 less 5% for provision for bad debts amounting to Rs. 500.

(x) Reserve for discount on creditors

A firm may like to create reserve for discount on its creditors to record discounts expected to be received from them. The adjustment entry for this purpose is as follows:

Reserve for Discount on Creditors Account	Dr.
To Profit and Loss Account	

The reserve for discount on creditors account is credited to the profit and loss account and it should be deducted from the sundry creditors in the balance sheet. Keeping with the principle of conservatism the provision for discount on creditors is often not found in actual practice.

Illustration 3:

A business house maintains provision of 5% against bad debts and 3% for discount on debtors and a reserve for discounts on creditors at 2%. On 1st April, 2005 it had the following balances:

Provision for Bad and Doubtful Debts	...	Rs. 5,000
Provision for Discount on Debtors	...	Rs. 2,850

Provision for Discount on Creditors ... Rs. 4,800

During the year 2005-06, bad debts, discount allowed to debtors and discount received from creditors amounted to Rs. 3,950, Rs. 8,800 and Rs. 9,840 respectively while for 2006-07 they amounted to Rs. 1,800, Rs. 7,000 and Rs. 6,800 respectively. Sundry Debtors were Rs. 1,20,000 on March 31, 2006 and Rs. 80,000 on March 31, 2007. Sundry Creditors on these two dates were Rs. 2,10,000 and Rs. 1,95,000 respectively.

Show provision for bad debts account, provision for discount on debtors account and reserve for discount on creditors account alongwith relevant portions of profit and loss account.

Solution:

Provision for Bad Debts A/c					
Dr.			Cr.		
		Rs.			Rs.
2006			2005		
Mar. 31	To Bad Debts	3,950	Apr. 1	By Balance b/d	5,000
"	To Balance c/d	6,000			
			2006		
			Mar. 31	By Profit and Loss A/c (Balancing figure)	<u>4,950</u>
		<u>9,950</u>			<u>9,950</u>
2007			2006		
Mar. 31	To Bad Debts	1,800	Apr. 1	By Balance b/d	6,000
"	To Profit and Loss A/c (Balancing figure)	200			
"	To Balance c/d	<u>4,000</u>			
		<u>6,000</u>			<u>6,000</u>
			2007		
			Apr. 1	By Balance b/d	4,000

Provision for Discount on Debtors A/c					
Dr.			Cr.		
		Rs.			Rs.
2006			2005		
Mar. 31	To Discount Allowed	8,800	Apr. 1	By Balance b/d	2,850
	To Balance c/d	3,420			
			2006		
			Mar. 31	By Profit and Loss A/c (Balancing figure)	<u>9,370</u>
		<u>12,220</u>			<u>12,220</u>
2007			2006		
Mar. 31	To Discount Allowed	7,000	Apr. 1	By Balance b/d	3,420
"	To Balance c/d	2,280			
		<u>5,860</u>	2007		
			Mar. 31	By Profit and Loss A/c (Balancing figure)	<u>5,860</u>

9,280

9,280

2007

Apr. 1

By Balance b/d

2,280

Reserve for Discount on Creditors A/c

Dr.		Cr.
	Rs.	Rs.
2005		2006
Apr. 1	To Balance b/d 4,800	Mar. 31 By Discount Received 9,840
2006		By Balance c/d 4,200
Mar. 31	To Profit and Loss A/c (Balancing figure) 9,240	
	14,040	14,040
2006		2007
Apr. 1	To Balance b/d 4,200	Mar. 31 By Discount Received 6,800
2007	To Profit and Loss A/c (Balancing figure) 6,500	" By Balance c/d 3,900
Mar. 31	10,700	10,700
2007		
Apr. 1	To Balance b/d 3,900	

Profit and Loss Account for the year ended 31st March, 2006

Dr.		Cr.
	Rs.	Rs.
To Bad Debts: 3,950		By Discount Received 9,840
Add : New Provision for Bad and Doubtful Debts 6,000		Add: New Reserve for Discount on Creditors 4,200
	9,950	14,040
Less : Old Provision 5,000	4,950	Less: Old Reserve 4,800
		9,240
To Discount Allowed 8,800		
Add : New Provision for Discount 3,420		
	12,220	
Less: Old Provision 2,850	9,370	

Profit and Loss Account for the year ended 31st March, 2007

Dr.		Cr.
	Rs.	Rs.
To Discount		By Old Provision

allowed	7,000		for Bad and				
Add: New			Doubtful				
Provision			Debts	6,000			
for Discount	<u>2,280</u>		Less: Bad				
	9,280		Debts	1,800			
Less: Old			New				
Provision			Provision	<u>4,000</u>	<u>5,800</u>	200	for
Discount	<u>3,420</u>	5,860					
			By Discount				
			Received	6,800			
			Add: New				
			Reserve				
			for Discount	<u>3,900</u>			
					10,700		
			Less: Old				
			Reserve	<u>4,200</u>	6,500		

(xi) Interest on capital

It is a normal practice to charge business with interest on the capital employed in the business. The purpose is to know whether the profits of the business are more than what could be earned from simple investments outside business. Interest charged is an expense to the business but it is a gain to proprietor. The following adjustment entries are passed:

- (i) Interest on Capital Account Dr.
 To Capital Account
- (ii) Profit and Loss Account Dr.
 To Interest on Capital Account

Alternatively:

- Profit and Loss Account Dr.
 To Capital Account.

Interest on capital is debited to the profit and loss account and it is shown on the liabilities side of the balance sheet by way of addition to the capital.

(xii) Interest on drawings:

As business allows interest on capital, it also charges interest on drawings made by the proprietor. This is a gain to the business and an expense to the proprietor. The following adjustment entries are made:

- (i) Capital Account Dr.
 To Interest on Drawings Account
- (ii) Interest on Drawings Account Dr.
 To Profit and Loss Account

Alternatively:

- Capital Account Dr.
 To Profit and Loss Account

It is credited to the profit and loss account and shown on the liabilities side of the balance sheet by way of deduction from capital.

(xiii) Accidental loss of an asset

Sometimes due to earthquake, fire or accidents, some of the assets may be destroyed. The following entries are passed to make adjustments for such losses:

- (a) When loss is incurred
- | | |
|-------------------------|-----|
| Accidental Loss Account | Dr. |
| To Asset Account | |
- (b) When loss is transferred to profit and loss account
- | | |
|----------------------------|-----|
| Profit and Loss Account | Dr. |
| To Accidental Loss Account | |

But in case the assets destroyed are insured and something is recoverable from the insurance company such loss is reduced to this extent and the balance will be transferred to the profit and loss account and treated as loss. The amount to be debited in the profit and loss may of course be spread over three or four years i.e. it may be treated as deferred revenue expenditure.

(xiv) Accidental loss of stock

Sometimes, stock in trade is lost due to fire or theft. If the firm has insured the stock, then loss can be made good fully or partly by the insurance company. The following adjustment entries are made:

- (a) If the stock is fully insured, the whole loss is fully recoverable from the insurance company. The journal entry is:

Insurance Company Account	Dr.
To Trading Account	

Insurance company account is shown on the credit side of the trading account and in the balance sheet it is treated as an asset until the amount is received.

- (b) If the stock is not fully insured, the loss of stock covered by the insurance policy will be claimed from the insurance company and the rest will be treated as loss. The journal entry in this case is:

Insurance Company Account	Dr.
Profit and Loss Account	Dr.
To Trading Account	

- (c) If the stock is not insured, nothing is recoverable from the insurance company and the whole loss should be born by the firm. The journal entry is:

Profit and Loss Account	Dr.
To Trading Account	

Thus in all cases, trading account is credited with the gross amount of stock lost.

(xv) Manager's commission on net profits

Sometimes, the manager of a business may be given a commission based on a fixed percentage of the net profits of the business. There are two methods for the calculation of such commission.

- (a) Commission as a percentage of net profits before charging such commission, then:

Manager's commission : Profit before commission x Rate of commission

(b) Commission as percentage of net profits after charging such commission then:

$$\text{Manager's commission : } \frac{\text{Profit before commission} \times \text{Rate of commission}}{100 + \text{Rate of commission}}$$

The adjustment entry for such commission payable is as follows:

Profit and Loss Account	Dr.
To Commission Payable Account	

The commission payable is shown on the debit side of the profit and loss account and on the liabilities side of the balance sheet.

(xvi) Goods distributed as free samples

Sometimes in order to promote the sale of goods, some of the produced goods are distributed as free samples. It may be treated like an expenditure on advertisement and the following adjustment entry is passed:

Free Samples/Advertisement Account	Dr.
To Trading/Purchases Account	

It is shown on the credit side of the trading account or deducted from the purchases and is also shown on the debit side of profit and loss account as free samples or advertisement expenses.

(xvii) Drawings of goods by the proprietor for personal use

If goods have been withdrawn by the proprietor for personal use and no entry has been passed during the year, the following adjustment entry should be passed:

Drawings Account	Dr.
To Purchases Account	

Thus, goods are deducted from the purchases on the debit side of the trading account and included in proprietor's drawings which is ultimately deducted from the capital shown on the liabilities side of the balance sheet.

(xviii) Deferred revenue expenditure

The expenditure incurred in the initial stage but the benefit of which will be available in subsequent years is called deferred revenue expenditure. Part of such expenditure is written off in each year and the rest is capitalised. The adjustment entry to write off this expenditure is as follows:

Profit and Loss Account	Dr.
To Expense (Respective) Account	

The written off amount is debited to profit and loss account and shown as a deduction from the capitalised expense in the balance sheet.

(xix) Goods on sale on approval base

Sometimes goods are sold to customers on approval base. If consent is not received during the accounting period, it cannot be treated as sale. In such case, the following adjustment entries are passed:

- (i) Sales Account Dr.
 To Debtors Account (with sale price)
- (ii) Stock Account Dr.
 To Trading Account (at cost price)

Thus, this item is shown on the credit side of trading account by way of deduction from the sales at sale price and added to the closing stock at cost price. At the same time it is shown on the asset side as a deduction from sundry debtors at sale price and added to the closing stock at cost price.

(xx) Goods received but not recorded in books

Often, goods may have been received but invoice has not been received or omitted to be recorded. In such a case the following adjustment entry should be passed.

- Purchases Account Dr.
 To Creditors Account

This item is shown as addition to the purchases in the trading account and added to sundry creditors on the liabilities side of the balance sheet.

(xxi) Salary to proprietor

If the proprietor charges salary for the work done by him, proprietor's salary account is debited and capital account is credited. If there are a number of proprietors called the partners, and salary is charged by them, salary to partners account will be debited and the respective capital accounts will be credited with the respective amounts of salary charged by them.

(xxii) Cash discount

Cash discount is allowed and received for prompt payment. When cash discount is allowed, a less sum is accepted as a full payment of a debt. Similarly when cash discount is received, a less sum is paid in full discharge of a liability. Discount allowed is debited to discount allowed account, cash received is debited to cash account and the total amount is credited to debtor making the payment. Discount received is credited to discount received account, cash paid is credited to cash account and the total of the two is debited to the creditor to whom the payment is made.

(xxiii) Trade Discount

Trade discount is a deduction from the list (or catalogue) price allowed by the wholesalers to the retailers for various reasons. The rate of trade discount allowed varies considerably. From accounting point of view no entries are made either in seller's book or in the purchaser's books for such discount. Entries for purchases and sales are made at net price i.e. after deducting trade discount from the list price.

The following are the points of distinction between cash discount and trade discount:

<i>Cash discount</i>	<i>Trade discount</i>
(i) It is a reduction granted by a supplier from the invoice price in consideration of immediate or prompt payment.	It is a reduction granted by a supplier from the list price of goods or services on business consideration.
(ii) It is allowed to encourage the prompt payment.	It is allowed to promote the sales.
(iii) It is not shown in the invoice	It is shown by way of deduction in the

	invoice itself.
(iv) Cash discount account is opened in the ledger.	Trade discount account is not opened in the ledger.
(v) It is allowed on payment of money	It is allowed on purchase of goods
(vi) It may vary with the time period within which payment is received	It may vary with the quantity of goods purchased or amount of purchases made.

The list given above are not exhaustive adjustment entries. You may analyse each transaction and pass necessary journal entries for adjustments. In short, you may note the following principles for the preparation of final accounts:

- (i) the items given in the trial balance will appear in only one of the statements i.e. the Trading Account, the Profit and Loss Account or the Balance Sheet, and
- (ii) the amount in respect of adjustments will appear in two of the above mentioned statements, normally in the Balance Sheet and in the Trading Account or in the Profit and Loss Account.

The reason being that for items appearing in the trial balance, the double entry has already completed but in respect of adjustments, the double entry has yet to be completed, hence two accounts will be affected.

21. CLOSING ENTRIES

In order to prepare final accounts, all nominal accounts have to be transferred to Trading and Profit and Loss Account. It is done by passing journal entries which are called closing entries as they close the nominal accounts. The entry to transfer the balance of profit and loss account itself is also one of the closing entries.

Consider the following entries and the final accounts resulting thereof, (figures are assumed):

		Rs.	Rs.
Trading Account	Dr.	1,26,800	
To Stock (1.4.2006)			21,000
To Purchases			98,000
To Sale Returns			6,000
To Carriage Inwards			1,800
(Transfer of various accounts to Trading Account)			
Sales Account	Dr.	1,17,000	
Purchase Returns	Dr.	2,500	
Stock (31.3.2007)	Dr.	27,950	
To Trading Account			1,47,450
(Transfer of sales account and purchases returns account to trading account and recording of stock on 31.3.2007)			
Trading Account	Dr.	20,650	
To Profit and Loss A/c			20,650
(Transfer of gross profit from trading account to profit and loss account)			
Profit and Loss Account	Dr.	11,150	
To Rent			2,400
To Salaries			4,800
To Sundry Expenses			950
To Depreciation			3,000

(Transfer of various nominal accounts to profit and loss account)

Interest Received	Dr.	Rs. 2,500	Rs. 2,500
To Profit and Loss A/c			

(Transfer of credit balance of interest received account to profit and loss account)

Profit and Loss Account	Dr.	12,000	
To Capital Account			12,000

(Transfer of net profit to capital account)

Trading and Profit and Loss Account for the year ended 31st March, 2007

Dr.		Cr.	
Rs.		Rs.	
To Opening Stock	21,000	By Sales	1,17,000
“ Purchases	98,000	Less: Sales	
Less: Purchases		Returns	<u>6,000</u>
Returns	<u>2,500</u>		1,11,000
	95,500		
To Carriage Inwards	1,800	By Closing Stock	27,950
“ Profit and Loss A/c	20,650		
[transfer of gross profit]			
	<u>1,38,950</u>		<u>1,38,950</u>
To Rent	2,400	By Trading Account -	20,650
“ Salaries	4,800	Gross profit	
“ Sundry Expenses	950	” Interest Received	2,500
“ Depreciation	3,000		
“ Capital A/c	12,000		
[transfer of net profit]			
	<u>23,150</u>		<u>23,150</u>

Illustration 4:

Following is the trial balance of Amar Nath as on 31st March, 2007 :

	Rs.	Rs.
Capital Account		80,000
Drawing Account	6,000	
Stock (1.4.2006)	45,000	
Purchases	2,60,000	
Sales		3,10,000
Furniture	10,000	
Sundry Debtors	40,000	
Freight and Octroi	4,600	
Trade Expenses	500	
	Rs.	Rs.
Salaries	5,500	
Rent	2,400	
Advertising Expenses	5,000	

Insurance Premium	400	
Commission		1,300
Discount	200	
Bad Debts	1,600	
Provision for Bad Debts		900
Creditors		20,000
Cash in hand	5,200	
Bank	5,800	
Goodwill (at cost)	<u>20,000</u>	
	<u>4,12,200</u>	<u>4,12,200</u>

Adjustments:

- Stock on 31st March, 2007 was valued at Rs. 53,000.
- Salaries have been only for 11 months.
- Unexpired insurance included in the figure of Rs. 400 appearing in trial balance is Rs. 100.
- Commission earned but not yet received amounting to Rs. 122 is to be recorded in books of account.
- Provision for bad debts is to be brought upto 3% of sundry debtors.
- Manager is to be allowed a commission of 10% of net profits after charging such commission.
- Furniture is depreciated @10% per annum.
- Only 1/4th of advertising expenses are to be written off.

Prepare trading and profit and loss account for the year ended 31st March, 2007 and balance sheet as on that date. Also show adjustments entries and closing entries.

Solution:

Mr. Amar Nath
Trading and Profit and Loss Account
for the year ended 31st March, 2007

Dr.			Cr.		
Rs.			Rs.		
To	Stock (1.4.2006)	45,000	By	Sales	3,10,000
"	Purchases	2,60,000	"	Stock (31.3.2007)	53,000
"	Freight and Octroi	4,600			
"	Gross Profit transferred to Profit and Loss Account	53,400			
		3,63,000			3,63,000
Rs.			Rs.		
To	Trade Expenses	500	By	Gross Profit transferred from Trading Account	53,400
"	Salaries	5,500			
	Add: Outstanding Salaries	500	"	Commission	1,300
		6,000		Add: Commission earned but not received	122
"	Rent	2,400			1,422
"	Advertising Expenses	5,000			
	Less: Amount Carried Forward	3,750			
		1,250			

“ Insurance Premium	400		
Less: Unexpired Insurance	<u>100</u>	300	
“ Discount		200	
“ Provision for Bad Debts @3% on Rs. 40,000	1,200		
Add: Bad Debts	<u>1,600</u>		
	2,800		
Less: Old Provision	<u>900</u>	1,900	
“ Depreciation		1,000	
“ Commission payable to Manager		3,752	
“ Net Profit transferred to Capital Account	<u>37,520</u>		
	<u>54,822</u>		<u>54,822</u>

Mr. Amar Nath
Balance Sheet as on 31st March, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital		Fixed Assets:	
Opening Balance	80,000	Goodwill (at cost)	20,000
Add: Net Profit	<u>37,520</u>	Furniture	10,000
	1,17,520	Less: Depreciation	<u>1,000</u>
Less: Drawings	<u>6,000</u>	Current Assets:	
	1,11,520	Unexpired insurance	100
Creditors	20,000	Unexpired advertising expenses	3,750
Outstanding salary	500	Commission earned but not received	122
Commission payable to manager	3,752	Stock	53,000
	<i>Rs.</i>		<i>Rs.</i>
		Sundry Debtors	40,000
		Less : Provision	
for bad debts	<u>1,200</u>	38,800	
		Cash at bank	5,800
	<u>1,35,772</u>	Cash in hand	<u>5,200</u>
			<u>1,35,772</u>

Journal

Adjustment Entries

		<i>Rs.</i>	<i>Rs.</i>
(a) Stock Account	Dr.	53,000	
To Trading Account			53,000
<u>(Being closing stock credited to trading account)</u>			

(b) Salaries Account	Dr.	500	
To Salary Outstanding Account			500
(Being the amount of salary outstanding on 31st March, 2007)			
(c) Unexpired Insurance	Dr.	100	
To Insurance Premium Account			100
(Being the amount of unexpired insurance premium as on 31st March, 2007)			
(d) Commission Earned but not Received Account	Dr.	122	
To Commission			122
(Being the amount of commission earned but not received till 31st March, 2007)			
(e) Bad Debts Account	Dr.	1,600	
To Provision for Bad Debts Account			1,600
(Transfer of bad debts to provision for bad debts)			
(f) Profit and Loss Account	Dr.	1,900	
To Provision for Bad Debts Account			1,900
(Being credit given to provision for bad debts to make its balance 3% of Rs. 40,000)			
(g) Profit and Loss Account	Dr.	3,752	
To Commission Payable to Manager			3,752
(For Commission payable to manager @10% of net profits remaining after charging such commission)			
		Rs.	Rs.
(h) Depreciation Account	Dr.	1,000	
To Furniture Account			1,000
(Being the amount of depreciation provided on furniture @10% per annum)			
(i) Unexpired Advertising Expenses Account	Dr.	3,750	
To Advertising Expenses Account			3,750
(For advertising expenses carried forward to next year)			

Closing Entries:

Trading Account	Dr.	3,09,600	
To Stock Account (1.4.2006)			45,000
To Purchases Account			2,60,000
To Freight & Octroi Account			4,600
(Transfer of various accounts showing debit balances to trading account)			
Sales Account	Dr.	3,10,000	
To Trading Account			3,10,000
(Transfer of sales account to trading account)			
<i>Note:</i> Entry for closing stock as it has already been passed by way of adjustment			
Trading Account	Dr.	53,400	
To Profit and Loss Account			53,400

(Transfer of gross profit from trading account to profit and loss Account)

Profit and Loss Account	Dr.	11,650	
To Trade Expenses Account			500
To Salaries Account			6,000
To Rent Account			2,400
To Advertising Expenses Account			1,250
To Insurance Premium Account			300
To Discount Account			200
To Depreciation Account			1,000

(Transfer of various nominal account showing debit balances to profit and loss account)

Commission Account	Dr.	1,422	
To Profit and Loss Account			1,422

(Transfer of credit balance in commission account to profit and loss Account)

		Rs.	Rs.
Profit and Loss Account	Dr.	37,520	
To Capital Account			37,520

(Transfer of net profit to capital account)

Note: Profit and Loss Account has already been debited in respect of provision for bad debts and commission payable to manager. Refer to adjustments entries.

22. LIMITATIONS OF FINANCIAL STATEMENTS

Financial statements are the result of the accounting process which begins with recording of transactions. Accounting process involves recording, classifying and summarising business transactions. Financial statements are the result of the third process viz. summarising. The financial statements are based on certain accounting concepts and conventions which can not be said to be foolproof.

The following are the limitations of the financial statements:

- (i) Financial statements are essentially interim reports and therefore, cannot be final because the final gain or loss can be computed only at the termination of the business. Financial statements only reflect the progress and position of the business at frequent intervals during its life.
- (ii) Financial statements though expressed in exact monetary terms, are not absolutely final and accurate. As the balance sheet is prepared on the basis of a going concern, asset valuation represents neither the realisable value nor replacement costs. Further, they depend on the judgement of the management in respect of various accounting policies.
- (iii) The values ascribed to the assets presented in the statements depend upon the standards of the persons dealing with them. For instance, the method of depreciation, mode of amortisation of fixed assets, treatment of deferred revenue expenditure, all depend on the personal judgement of the accountant.
- (iv) Financial statements take into consideration only the financial factors. They fail to bring out the significance of non-financial factors which may have considerable bearing on the operating results and financial conditions of an enterprise. For example, public image of the enterprise, the calibre of its management, efficiency and loyalty of its workers etc.
- (v) It is not always possible to discover false figures in financial statements. Unscrupulous

managements generally resort to 'window dressing' in the preparation of such statements.

- (vi) Financial statements are prepared primarily for shareholders. Other interested parties have to generally make many adjustments before they use them profitably.
- (vii) Quite often, financial statements do not disclose current worth of the business. Only historical facts are presented and the true current worth is not reflected.
- (viii) Owing to the fact that financial statements are compiled, on the basis of historical costs, while there is a marked decline in the value of the monetary unit and resultant rise in prices, the balance sheet loses its function as an index on current economic realities. Again the financial statements contain both historical and current costs items, hence figures are distorted.

23. MANUFACTURING ACCOUNT

A manufacturing concern may like to ascertain the cost of goods during the accounting period and may prepare Manufacturing Account for this purpose. Trading Account is not capable of showing the cost of goods manufactured because it deals with stock of finished goods also and because some of the expenses connected with manufacture of goods (such as depreciation and repairs of machinery and factory, land and building) are debited to the Profit and Loss Account. Manufacturing Account is debited with all expenses incurred in the factory on production of goods. This means that depreciation and repairs to plant and machinery and factory building, salary to works manager, etc. are also debited to this account. The total of such expenses plus cost of raw material used give cost of goods manufactured during the period. This is transferred to Trading Account which deals with stock of finished goods and sales also. The remaining nominal accounts appear in Profit and Loss Account.

In fact there is no prescribed format for the presentation of manufacturing account. However, a format covering various elements is given below.

Manufacturing Account for the year ended...			
Dr.			Cr.
Particulars	Rs.	Particulars	Rs.
To Work in progress (opening)	—	By Work in progress (closing)	—
To Raw material consumed:	—	By Sale of scrap	—
Opening stock	—	By Cost of production of finished	
Add: Purchases	—	goods transferred to	
Less: Closing stock	—	Trading Account	—
To Direct wages	—		
To Direct expenses	—		
To Factory expenses	—		
Factory rent	—		
Plant repairs	—		
Indirect wages	—		
Depreciation on			
factory building	—		
	—		—

The Trading Account and Profit and Loss Account should be prepared in the same way as discussed earlier.

Illustration 5:

Following are the balances in the ledger of Mr. Patel for the year ended 31st March, 2007:
Rs.

Stock (1.4.2006):		
Raw materials		1,00,000
Semi-finished goods		50,000
Finished goods		2,60,000
Purchases:		
Raw materials		8,00,000
Finished goods		1,70,000
Carriage inwards on raw materials		30,000
Manufacturing wages		1,00,000
Salary of the supervisor		36,000
Rent of the factory		70,000
Gas and water		30,000
Return of raw materials		13,000
Fuel and coal		33,000
Factory power		1,25,000
Fire insurance		13,000
Sales returns		1,20,000
Depreciation on factory building		12,000
Stock on 31.3.2007 :		
Raw materials		80,000
Semi-finished goods		1,30,000
Finished goods		2,20,000
Sales		22,00,000
Carriage outwards		35,000
Office salaries		1,50,000

Prepare manufacturing account and trading and profit and loss accounts for the year ended March, 2007.

Manufacturing Account for the year ended 31st March, 2007

Dr.		Cr.	
	Rs.	Rs.	Rs.
To Opening stock:		By Closing stock:	
Raw materials	1,00,000	Raw materials	80,000
Semi-finished		Semi-finished	
Goods	<u>50,000</u>	goods	<u>1,30,000</u>
	1,50,000		2,10,000
To Purchases	8,00,000	By Cost of production	
Less : Returns	<u>13,000</u>	transferred to	
	7,87,000	Trading Account	11,76,000
	Rs.		Rs.
To Carriage on raw			
materials	30,000		
To Manufacturing			
wages	1,00,000		
To Factory expenses:			

Salary of supervisor	36,000	
Rent of factory	70,000	
Gas and water	30,000	
Fuel and coal	33,000	
Factory power	1,25,000	
Fire insurance	13,000	
Depreciation	<u>12,000</u>	<u>3,19,000</u>
	13,86,000	13,86,000
	-----	-----

Trading and Profit and Loss Account for the year ended 31st March, 2007

	Rs.		Rs.
To Opening stock of finished goods	2,60,000	By Sales	22,00,000
To Cost of production transferred from Manufacturing Account	11,76,000	Less: Returns	<u>1,20,000</u>
To Purchases	1,70,000	By Closing Stock of finished goods	2,20,000
To Gross Profit b/d	<u>6,94,000</u>		
	<u>23,00,000</u>		<u>23,00,000</u>
To Carriage outwards	35,000	By Gross Profit c/d	6,94,000
To Office salaries	1,50,000		
To Net Profit transferred to Capital A/c	<u>5,09,000</u>		
	<u>6,94,000</u>		<u>6,94,000</u>
	-----		-----

Illustration 6:

From the following particulars of Mr. Murthy, prepare Manufacturing, Trading and Profit and Loss Account for the year ended 31.3.2007 and the Balance Sheet as on the date after making necessary adjustments:

	Rs.
Capital (1.4.2006)	2,50,000
Drawings account	70,000
Sundry creditors	80,000
Discount received	7,020
Bank overdraft	40,000
Provision for bad and doubtful debts	6,000
	Rs.
Purchases returns	5,300
Sales	6,75,000
Sales returns	860
Stock of finished goods (1.4.2006)	90,000
Plant and machinery (including machinery for Rs. 50,000 purchased on 1.1.2007)	1,70,000
Furniture	15,000
Building	1,50,000
Purchases	3,02,300
Sundry debtors	1,10,000

Manufacturing wages	60,000
Manufacturing expenses	50,000
Carriage inwards	4,000
Carriage outwards	4,200
Bad debts	1,500
Salaries	28,000
Interest and bank charges (Dr.)	1,260
Discount allowed	1,500
Insurance (Dr.)	3,000
Cash at bank	1,400
Cash in hand	300
Stock of finished goods (31.3.2007)	75,500

The following adjustments are to be made:

(i) Interest on capital at 10% p.a. (no interest is to be provided on drawings)

(ii) Outstanding expenses:

	<i>Rs.</i>
(a) Salaries	1,000
(b) Manufacturing wages	500
(c) Interest on bank loan	1,000

(iii) Depreciation on:

- (a) Machinery at 10%
- (b) Furniture at 10%
- (c) Building at 2.5%

(iv) Pre-paid expenses:

(a) Insurance	1,000
(b) Salary	500

(v) Provision for bad and doubtful debts at 10% on debtors.

Furniture costing Rs. 5,000 was sold for Rs. 3,500 on 1.4.2006 and this amount was latter credited to furniture account.

Solution:

Mr. Murthy
Manufacturing, Trading and Profit and Loss Account
as on 31st March, 2007

<i>Dr.</i>				<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>
To Purchases	3,02,300		By Trading A/c	
Less: Returns	<u>5,300</u>	2,97,000	(transfer of cost of	
To Carriage inwards		4,000	goods produced)	4,24,750
To Manufacturing wages	60,000			
Add: Outstanding	<u>500</u>	60,500		
To Manufacturing expenses		50,000		
To Depreciation on machinery		<u>13,250</u>		
		<u>4,24,750</u>		<u>4,24,750</u>

To Opening stock	90,000	By Sales	6,75,000	
To Manufacturing A/c goods produced)	4,24,750	Less: Returns	<u>860</u>	6,74,140 (cost of
To Gross profit c/d	<u>2,34,890</u>	By Closing stock		75,500
	<u>7,49,640</u>			<u>7,49,640</u>
To Salaries	28,000	By Gross profit b/d		2,34,890
Add : Outstanding	<u>1,000</u>	By Discount		7,020
	29,000			
Less : Pre-paid	<u>500</u>			
	28,500			
To Interest and bank charges	1,260			
Add : Outstanding	<u>1,000</u>			
	2,260			
To Discount allowed				1,500
To Insurance	3,000			
Less : Pre-paid	<u>1,000</u>			2,000
To Carriage outwards				4,200
To Provision for bad debts				6,500
To Loss on sale of furniture				1,500
To Depreciation:				
Building	3,750			
Furniture	<u>1,350</u>			5,100
To Interest on capital				25,000
To Net profit transferred to capital				
	<u>1,65,350</u>			
	<u>2,41,910</u>			<u>2,41,910</u>
	-----			-----

Mr. Murthy
Balance Sheet as on 31st March, 2007

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital	2,50,000		Fixed Assets		
Add: Profit	1,65,350		Building	1,50,000	
Interest	<u>25,000</u>		Less: Depreciation	<u>3,750</u>	1,46,250
	4,40,350		Plant and		
Less: Drawings	<u>70,000</u>	3,70,350	Machinery	1,20,000	
Current Liabilities:			Add: Additions		
Bank overdraft		40,000	(1.1.2007)	<u>50,000</u>	
Sundry creditors		80,000		1,70,000	
Outstanding expenses:			Less: Depreciation	<u>13,250</u>	1,56,750
Salaries	1,000		Furniture	18,500	
Manufacturing wages	500		Less: Cost of		
Interest on bank loan	<u>1,000</u>	2,500	furniture disposed-		
			during the year	<u>5,000</u>	
				13,500	
			Less: Depreciation	<u>1,350</u>	12,150
			Current Assets:		
			Stock		75,500

	Debtors	1,10,000	
	Less: Provision for bad and doubtful debts	<u>11,000</u>	99,000
	Cash at bank		1,400
	Cash in hand		300
	Pre-paid expenses:		
	Insurance	1,000	
	Salary	<u>500</u>	<u>1,500</u>
<u>4,92,850</u>			<u>4,92,850</u>
-----			-----

Working Note:

- (i) Provision for bad and doubtful debts:

	Rs.
Provision required	11,000
Add: Bad debts	<u>1,500</u>
	12,500
Less: Existing provision	<u>6,000</u>
	<u>6,500</u>

- (ii) Book value of furniture sold has been deducted for calculating depreciation.

SELF-TEST QUESTIONS

- State the considerations which would guide you in deciding whether any particular expense should be regarded as capital expenditure or revenue expenditure.
- State in each of the following cases whether the expenditure is (a) capital expenditure, (b) revenue expenditure, or (c) deferred revenue expenditure.
 - Repairs to furniture.
 - Legal expenses incurred to defend a suit for breach of contract to supply goods.
 - Custom duty paid on imported machinery.
 - Heavy expenditure incurred on advertising a new product.
 - Carriage paid on goods purchased.
 - Amount spent to overhaul a motor truck purchased second hand.
 - Wages paid to workers for setting up a new machinery.
 - Preliminary expenses incurred in setting up a joint stock company.
 - Wages paid to workers for converting raw material into finished goods.
 - Office rent paid in advance for three years.

[Ans. : Revenue items = (i), (ii), (v), (ix); Capital items = (iii), (vi), (vii), (viii); Deferred revenue items = (iv), (x)]

3. Fill in the blanks:

- Trading account reveals profit or ... loss.
- Profit and loss account reveals ... profit or...loss.
- Manufacturing account shows cost of....
- Expenses appear on...side of trading and profit and loss account.
- Deferred revenue expenditure is written off over a.... of years.
- Capital appears on...side of balance sheet.
- Provision for bad debts account shows....balance.

(viii) Reserve for discount on creditors account shows.....balance.

(ix) Carriage inwards appear in....account, whereas carriage outwards appear in....account.

4. Tick the correct answers:

- | | |
|--|--|
| (i) What type of account goodwill is? | Fictitious/Intangible |
| (ii) What type of account furniture is? | Fixed/Current |
| (iii) On which side of balance sheet is unexpired insurance shown? | Assets/Liabilities |
| (iv) Which type of items appear in profit and loss account | Revenue/Capital/Both
Revenue and Capital |
| (v) Is balance sheet an account or a statement? | An Account/A Statement |
| (vi) Where will amount spent on stationery appear? | In Profit and Loss Account/
In Balance Sheet. |

5. Decide whether the following statements are true or false:

- (i) Trade expenses account is transferred to trading account.
- (ii) Capital account appears on asset side of balance sheet.
- (iii) Drawing account is a revenue expenditure to be shown on debit side of profit and loss account.
- (iv) If trading account reveals gross loss, profit and loss account results in net profit in any case.
- (v) Interest on capital and salary to proprietor are incomes and hence are shown on credit side of profit and loss account.

[Ans. : All statements are false].

6. What are opening entries, closing entries and adjustment entries? Give examples.

7. The following are the names of assets. Classify them:

- (i) Leasehold premises
- (ii) Accounting machines
- (iii) Coal mine
- (iv) Goodwill
- (v) Stock of raw materials
- (vi) Motor vehicles
- (vii) Cash in hand
- (viii) Government securities
- (ix) Copyright of book (no longer in demand)
- (x) Amount due from customers
- (xi) Loose tools
- (xii) Cost of floating a company

[Ans.: Fixed: (i), (ii), (iv), (vi); Wasting: (iii); Intangible: (iv); Fictitious: (ix), (xii); Current: (v), (vii), (viii), (x) and (xi); Liquid: (vii), (viii)].

8. Define an asset and discuss the various types of assets. Classify the following assets into fixed, current and fictitious assets, mentioning sub-types, also in the case of fixed assets:

- (i) Land and buildings
- (ii) Furniture

- (iii) Bills receivable
- (iv) Cash in hand
- (v) Cash at bank
- (vi) Plant and machinery
- (vii) Coal mine
- (viii) Loose tools
- (ix) Preliminary expenses
- (x) Stock in trade
- (xi) Amount due from customers
- (xii) Copyright of a book, no longer in demand
- (xiii) Stone quarries
- (xiv) Livestock
- (xv) Motor vehicles
- (xvi) Government bonds
- (xvii) Goodwill of a firm incurring heavy losses.

[Hint : (ix), (xii), (xvii) are fictitious assets].

9. Arrange the following assets in order of their liquidity:

Furniture, Goodwill, Stock in trade, Unexpired insurance, Cash in hand, Trade debtors, Readily saleable investments, Cash at bank, Land, Buildings, Machinery, Bills receivable.

[Ans.: Cash in hand, Cash at bank, Saleable investments, Bills receivable, Trade debtors, Stock in trade, Prepaid insurance, Furniture, Machinery, Buildings, Land, Goodwill].

10. Arrange the following liabilities in order of urgency:

Capital	Creditors for expenses
Sundry trade creditors	Loan
Bills payable	

[Ans.: Creditors for expenses, Sundry trade creditors, Bills payable, Loan, Capital].

11. The following are the balances taken from the books of Mr. Atma Ram:

Balances on 31st March, 2007

	Rs.
Atma Ram's capital	30,000
Atma Ram's drawings	5,000
Furniture and fittings	2,600
Bank overdraft	4,200
Creditors	13,300
Business premises	20,000
Stock on 1st April, 2006	22,000
Debtors	18,600
Rent from tenants	1,000
Purchases	1,10,000
Sales	1,50,000
Sales returns	2,000
Discount-debit	1,600
Discount-credit	2,000
Taxes and insurance	2,000
General expenses	4,000

Salaries	9,000
Commission-debit	2,200
Carriage on purchases	1,800
Provision for bad and doubtful debts	600
Bad debts written off	800

Stock on hand on 31st March, 2007 was estimated at Rs. 20,000. Rent Rs. 300, is still due from the tenant. Salaries, Rs. 750 are as yet unpaid. Write off bad debts Rs. 600 and depreciate business premises by Rs. 300 and furniture and fittings by Rs. 266. Make a provision of 5% on debtors for bad and doubtful debts and provision of 2% for discounts. Allow interest on capital at 5 per cent and carry forward Rs. 700 for unexpired insurance. The manager is entitled to a commission of 10% on profits remaining after charging his commission.

Prepare Trading Account, Profit and Loss Account and Balance Sheet on 31st March, 2007.

Hints : Suspense Account (difference in trial balance) = 500.

[Ans. : G.P = 34,200, N.P. = 13,220, B/s Total = 59,792].

12. Below is the trial balance of Suresh as at 31st March, 2007.

<i>Debit Balance</i>	<i>Rs.</i>	<i>Credit Balance</i>	<i>Rs.</i>
Suresh's Current Account	1,500	Capital Account	50,000
Adjusted purchases	6,99,200	Loan from Mohan @9%	
Salaries	4,200	(taken on 1st October, 2006)	20,000
Carriage on purchases	400	Sales	7,20,000
Carriage on sale	500	Discount	500
Lighting	300	Sundry creditors	20,000
Rates and insurance	400		
Buildings	27,000		
Sundry debtors	8,000		
Furniture	6,000		
Cash in hand	250		
Cash at bank	1,500		
Stock (31st March, 2007)	<u>61,250</u>		
	<u>8,10,500</u>		<u>8,10,500</u>

Rates have been prepaid to the extent of Rs. 175. Bad debts totaling Rs. 500 have to be written off. A provision for doubtful debts @5% on debtors is necessary. Buildings have to be depreciated at 2% and furniture @10%. The manager is entitled to a commission of 5% of net profits before charging such commission.

You are required to prepare the profit and loss account for the year ended 31st March, 2007 and the balance sheet as on that date.

[Hints : 1. The trial balance gives "Adjusted Purchases". It means that the opening stock has already been transferred to the Purchases Account and has thus been closed. Further, entry for closing stock has already been passed by debiting the Closing Account and crediting Purchases Account. That is why closing stock appears in the trial balance. It will now be shown in the Balance Sheet and not in the Trading Account since Purchases already stand reduced.

2. There is a loan of Mohan @ 9% taken in October, 2006. The trial balance makes no mention of any interest being paid to him. Hence, interest @9% must be provided for six months i.e. from October 2006 to March 2007.

[Ans.: G.P. = 20,400, N.P. =12,122, Total B/S =1,02,160].

13. The following figures were taken from the books of Amar on 31st March, 2007.

	Rs.		Rs.
Cash at bank	26,400	Royalties received	400
Cash in hand	30	Trade and general expenses	5,020
Sales	2,61,230	Reserve on patents	5,000
Stock (1st April, 2006)	27,410	Interest on loan	1,240
Sales returns	3,300	Repairs	840
Discount (Dr.)	6,380	Sundry creditors	20,780
Bills receivable	1,820	Buildings	95,820
Sundry debtors	52,720	Patent rights	50,000
Depreciation	4,780	Loan (raised on	
Purchases	1,84,030	mortgage of buildings)	45,000
Discount on purchases	3,900	Agent's commission	6,500
Wages	14,040	Bad debts	1,900
Provision for bad debts	5,400	Plant and machinery	30,000
Provision for discounts		Capital	2,00,000
on debtors	1,970	Drawings	30,000
		Advertising	1,000
		Carriage	450

In addition, the following information is given:

- Stock on 31st March, 2007 was 32,250.
- The stock includes materials worth Rs. 2,250 for which bills had not been received and, therefore, not accounted for yet.
- During the year a sum of Rs. 3,000 was paid as ground rent for 2006-07 and 2007-08. This sum stands debited to buildings account.
- Included in sales is an amount of Rs. 7,500 representing goods on sale or return, the customers still having the right to return the goods. The goods invoiced were showing a profit of 20% on sales.
- A customer's bill for Rs. 2,780 had been discounted with bank. The bank has sent an intimation that the bill has been dishonored. No entry has yet been passed in respect of this.
- A provision for bad debts is to be maintained at 5% of the debtors and a provision for discounts on debtors is also to be maintained at 2% of the debtors.

Prepare trading and profit and loss account of Amar for the year ended 31st March, 2007 and his balance sheet as on that date.

[Hints :

- Prepare a trial balance.
- Please note that depreciation appears in the trial balance. This means that the assets concerned have already been credited in respect of depreciation.
- Goods purchased, Rs. 2,250 have not yet been brought into account. pass the necessary entry.
- Goods sold on "sale on return" means the buyer may return the goods until the right to return the good expires. Therefore, it should not be treated as a "sale". See the following entry:

Sales Account	Dr.	7,500	
To Sundry Debtors			7,500

This will reduce both sale and debtors.

Goods lying with the customers should be included in stock at cost. The cost is Rs. 7,500 less 20% i.e., Rs. 6,000.

- Pass entry for bills discounted, dishonored and make consequential changes.

6. Provision for bad debts will be Rs. 2,400 (calculate how this figure has been arrived at).

7. Provision for discount will be Rs. 912 [calculate how it has been arrived at.]

[Ans.: G.P. = Rs. 60,500; N.P. = Rs. 39,698; Total of B/S = Rs. 2,77,728].

14. Mr. T.P.'s trial balance as on 31st March, 2007 is as under:

<i>Debit Balance</i>	<i>Rs.</i>	<i>Credit Balance</i>	<i>Rs.</i>
Land and building	20,000	Capital	80,000
Machinery	50,000	Sundry creditors	8,000
Furniture and fixtures	4,000	Discounts received	400
Opening stock	16,300	Outstanding expenses	1,550
Purchases	80,000	Sales	1,50,500
Salaries	6,000	Repairs and renewals provision	2,000
Carriage on sales	1,500		
Freight on purchase	8,000		
Advertising	5,400		
Wages	15,000		
Rent	3,000		
Postage and stationery	1,500		
General expenses	3,200		
Loan to Santhanam			
9% (given on 1st Oct., 2006)	5,000		
Prepaid insurance	200		
Sundry debtors	20,000		
Cash in hand	250		
Cash in bank	3,100		
	<u>2,42,450</u>		<u>2,42,450</u>

The following further information is given:

- Stock on 31st March, 2007 was Rs. 14,900.
- Machinery was purchased on 31st October, 2006 for Rs. 10,000 and was installed by own workmen. The wages for this purpose amounted to Rs. 500. This amount is included in wages account.
- Depreciation is to be written off @
 - 3% on land and buildings
 - 10% on machinery; and
 - 5% on furniture and fixtures.
- Provision for repairs and renewals is credited with Rs. 1,500 every year.
- A reserve of 2% is to be made on creditors for discount.

From the information given above, prepare trading account and profit and loss account for the year ended 31st March, 2007 and balance sheet as at that date.

[Hints:

- Prepaid insurance and outstanding expenses are given in trial balance. This means double entry in respect of these of items has been completed. Therefore, they will appear in balance sheet only.
- There is a provision for repairs and renewals. Actual repairs will, therefore, be debited to this account and not to the profit and loss account, the provision for repairs and renewals account will be credited by Rs. 1,500 by debiting profit and loss account.]

Suggested Readings :

- (1) *Ashok Sehgal & Deepak Sehgal* — Advanced Financial Accounting
 - (2) *R.L. Gupta & V.K. Gupta* — Financial Accounting
 - (3) *S.P. Jain & K.L. Narang* — Financial Accounting
 - (4) *J.R. Monga* — Advanced Financial Accounting
 - (5) *M.C. Shukla, T.S. Grewal & S.C. Gupta* — Advanced Accounts, Vol. I.
-

STUDY VI**ACCOUNTING FOR DEPRECIATION****1. MEANING OF DEPRECIATION**

Business enterprises acquire different types of fixed assets depending up on its requirements and financial conditions. It is known that fixed assets have long life and are held for use in the business for production of goods and services and have a material value. It is a common experience that whenever an asset is used in business its value is getting reduced and sooner or later the asset will become useless. Thus, depreciation is a permanent, continuing and gradual shrinkage in the book value of a fixed asset. It is the fall in the quality or value of a fixed asset through physical wear and tear due to use or passage of time or from any other cause. Depreciation takes place irrespective of regular repairs and maintenance. As the asset is used for business purpose, the annual loss in the value of the asset is like any other expense hence the cost of asset should be treated as a loss spreading over its life. The cost of assets used for business purposes has to be written off over its useful economic life. Useful life of an asset is either the period over which a depreciable asset is expected to be used by the organization or the number of production or similar units expected to be obtained from the use of the asset by the organization. Thus, depreciation is a process of allocating the cost of a fixed asset over its estimated use in a rational and systematic manner.

Depreciation is that portion of the cost of an asset which is deducted from revenue for asset's use while conducting the business operation. Pickles has defined it as "the permanent and continuing diminution in the quality, quantity or value of an asset".

The Institute of Chartered Accountants of India has defined it as "a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined."

Depreciation Accounting has been defined by the American Institute of Certified Public Accountants as " a system of accounting which aims to distribute the cost or other basic value of tangible capital assets less salvage (if any) over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation and not of valuation."

2. ACCOUNTING CONCEPT OF DEPRECIATION

Depreciable assets are assets which (i) are expected to be used more than one accounting period; (ii) have a limited useful life and (iii) are held by the organization for use in the production or supply of goods and services. When a fixed asset is purchased, it is recorded in the books of account at its original cost. But, the fixed asset is used to earn revenues for a number of accounting periods in future with the same acquisition cost until the concerned fixed asset is sold or discarded. It is therefore necessary that a part of the acquisition cost of the fixed asset is treated or allocated as an expense in each of the accounting period in which the asset is used up. This allocation of cost in the form of an expense is known as depreciation in accounting. For instance, a business purchases a machinery for Rs. 10,00,000 and after using or utilizing it for five years, it is sold for Rs. 2,00,000. The cost of the machinery used in the business is Rs. 8,00,000 (Rs. 10,00,000 – Rs. 2,00,000). This cost must be allocated as an expense of the business at the rate of Rs. 1,60,000 ($8,00,000 \div 5$) for each of five accounting periods in which the machinery has been used to earn revenues. This Rs. 1,60,000 charge as expenses is called accounting concept of depreciation. It is the cost for the services obtained from the use of the asset in the same manner as the cost for wages, rent, etc. Depreciation is the expense charged to profit and loss account before arriving at the net profit for the year. In other words, the cost of fixed assets in the form of depreciation has to be matched against the revenues of the years over which the asset is used.

In accounting, depreciation means apportionment or allocation of the cost of the fixed assets over its useful life. Its aim is to spread over and allocate or distribute the cost of the fixed asset to the years of its use and charge the depreciable cost to profit and loss account before arriving at the profits of each the accounting periods in which the fixed asset has been utilized.

Provision for depreciation in the profit and loss account does not involve the outflow of cash and hence funds to the extent of depreciation charge over the years will remain in the business and these funds can be easily used for replacement of asset. The primary purpose of depreciation accounting is cost allocation.

The following factors are emphasized to explain the concept of depreciation accounting : (i) Depreciation accounting is the process of allocating the cost of the tangible fixed asset less its salvage value over its serviceable life. (ii) Depreciation is an expense that is to be charged against the revenue whether the business makes profit or incurs loss; (iii) Depreciation provides funds for replacing the asset when its useful life ends. Depreciation is not a process of valuation but it is an allocation. Even if the market value of an asset increases, depreciation has to be recorded because of allocation process.

3. CHARACTERISTICS OF DEPRECIATION

The following are the important characteristics of depreciation:

- (i) Depreciation refers to a permanent/gradual and continuous decrease in the utility value of a fixed asset and it continues till the end of the useful life of the asset.
- (ii) Depreciation is a charge against profit (i.e. revenue earned) for a particular accounting period.
- (iii) Depreciation is always computed in a systematic and rational manner since it is not a sudden loss.
- (iv) Depreciation is a process of allocation of expired cost and not of valuation of fixed assets.
- (v) Whatever method for calculating depreciation is followed, the exact amount can never be calculated, it can simply be estimated.
- (vi) Depreciation may be due to physical factors and functional factors.
- (vii) The fundamental objects of depreciation are - (a) to maintain the nominal capital invested in fixed assets, and (b) to allocate the expired portion of the cost of fixed assets against a number of accounting periods.

- (viii) Depreciation is a must, i.e. it always takes place whether the asset is carefully handled or neglected or it is a very costly one etc.
- (ix) If the market value of a fixed asset is fluctuating, the same does not affect the amount of depreciation so made on the respective assets.
- (x) Depreciation is calculated in respect of fixed assets only, i.e. plant, machinery, furniture etc.
- (xi) Depreciation accounting is a process of allocating the depreciable cost (cost less scrap value) over the estimated useful life of the fixed asset.
- (xii) Depreciation charge is not an exact amount but based on estimates.
- (xiii) Total depreciation cannot exceed its depreciable value (cost less scrap value) or original cost where the scrap value is nil.

4. CAUSES OF DEPRECIATION

- (1) *Physical wear and tear resulting from use* : Tangible fixed assets like, machinery, buildings, furniture etc. get worn out or torn out on account of friction, strain, weathering, intensity of use, chemical reaction, handling etc. This is the most important cause of charging depreciation in respect of such assets which lose their value on account of constant use.
- (2) *Physical deterioration resulting from exposure to the elements* : Number of assets deteriorate with mere passage of time, being continually exposed to forces of nature, like, winds, weather etc.
- (3) *Disuse* : A machine kept continuously idle becomes potentially less useful by the passage of time.
- (4) *Depletion* : Wasting assets such as mines and quarries lose their value because they get exhausted on account of continuous extractions.
- (5) *Obsolescence* : There may be cases where a slackening or even cessation of demand for services rendered by the asset may bring about fall in its value. Such a fall in demand may be due to a number of causes e.g. technical changes within the industry, technical progress in other industries, changes in tastes and habits of consumers, changes in supply and locations of natural resources etc.
- (6) *Accidents* : If an asset meets with an accident, the value of asset may go down.

5. OBJECTIVES OF PROVIDING DEPRECIATION

The following are the objectives of providing depreciation:

- (i) *To ascertain the correct profits* : It is reasonable that when a particular asset is used for earning the income of the business, the reduction in the value of assets should be provided from the income in order to calculate the correct and real profit of the business.
- (ii) *To present true financial position* : In order to show the true financial position of the business in the balance sheet it is necessary that assets must be shown at their true value after deducting reasonable depreciation. If depreciation is not provided, the assets will be overstated in the financial statements and it will be against the true sense of business principles.
- (iii) *To make provision for replacement of assets* : Since depreciation is a non-cash expense, the amount charged can be kept separately and utilised for the replacement of the asset after the expiry of the life of the asset.
- (iv) *To ascertain the proper cost of the product* : In order to ascertain the cost of production, it is necessary to charge depreciation as an item of cost of production.

- (v) *Uniform rate of return is ensured* : This presupposes ideal matching of expired cost against the related revenue and proper measurement of depreciable asset at each accounting date.
- (vi) To maintain the capital invested in the cost of the asset intact in the business so that it can be reinvested in profit earning process.
- (vii) Maximum tax benefit can be derived.
- (viii) *To meet the legal requirements* : In the case of joint stock companies , it is necessary to charge depreciation on fixed assets before declaring dividends.

6. FACTORS IN MEASUREMENT OF DEPRECIATION

It is not an easy task to calculate the exact amount of depreciation as it depends on a number of factors which are given below:

- (i) The original cost of asset. The cost includes all cost incurred in acquiring the asset, i.e. purchase price including transportation and installation costs, if any.
- (ii) The additions, if any, made to the assets during the year taking into consideration the date on which these additions were made.
- (iii) The estimated useful life of the asset.
- (iv) The scrap or the residual value of asset.
- (v) Obsolescence, i.e., the chance of the asset going out of fashion.
- (vi) The working hours of the asset concerned.
- (vii) The repairs and renewals.
- (viii) The skill of the operators who handle the assets.
- (ix) The legal provisions or other restrictions relating to depreciation.

7. ACCOUNTING TREATMENT

When the depreciation is directly charged to asset account the entry to be made on writing off depreciation is:

Depreciation Account	Dr.
To Asset Account	

When depreciation is directly credited to the asset account, the same is shown in the balance sheet at its cost or book value *less* depreciation to the accounting period. i.e. the asset appears at its reduced value in the balance sheet. The depreciation account is transferred to the debit of profit and loss account.

Profit and Loss Account	Dr.
To Depreciation Account	

Alternatively, when the asset continues to be shown at its original cost till discarded or destroyed or sold the following entries may be passed:

(i) Depreciation Account	Dr.
To Provision for Depreciation Account	

For transferring depreciation account the journal entry will be:

(ii) Profit and Loss Account	Dr.
To Depreciation Account	

In this method, the asset account is not affected by the amount of depreciation and the value of asset appears in the ledger and the balance sheet at its original cost until it is sold or discarded. The amount of depreciation written off is accumulated in provision for depreciation

account. However, where the asset is sold or discarded or exchanged for a new asset, the total accumulated depreciation for that asset in the provision for depreciation account is transferred to that asset account by the following journal entry.

Provision for Depreciation A/c	Dr.
To Relevant Asset A/c	

Thus the balance in the provision for depreciation account always shows the accumulated depreciation on the assets in service or unsold assets. In the balance sheet, the asset account is shown at its original cost *less* accumulated balance in the provision for depreciation account.

In the Assets Side of the Balance Sheet

Relevant Asset	-----
Less: Provision for Depreciation	-----

Alternatively the Asset Account is shown at its original cost in the assets side and Provision for Depreciation Account in the Liability Side until the depreciation provision is equal to the original cost of the asset.

8. METHODS OF PROVIDING DEPRECIATION

The various methods of providing depreciation are:

A. *Uniform charge methods :*

- (i) Fixed instalment method
- (ii) Depletion method
- (iii) Machine hour rate method.

B. *Declining charge depreciation methods:*

- (i) Diminishing balance method
- (ii) Sum of years digits method
- (iii) Double declining method

C. *Other methods:*

- (i) Group depreciation method
- (ii) Inventory system (valuation method) of depreciation
- (iii) Depreciation fund method
- (iv) Insurance policy method
- (v) Annuity method

A. *Uniform charge methods*

Depreciation is charged uniformly every year for those assets which are uniformly productive. Three methods fall in this category:

(i) *Fixed Instalment Method or Straight Line Method* : Under this method, a fixed proportion of the original cost of the asset is written off each year so that asset account may be reduced to its residual value at the end of its estimated economic useful life. It is assumed that depreciation is a function of time.

Sometimes it happens that some additional assets are purchased during the year. They must be depreciated only from the date of purchase to the close of the accounting period. When no date is mentioned, depreciation may be charged for half of the year on the assumption that addition was made in the middle of the year. If some assets are sold during the year, their depreciation should be calculated on those assets from the beginning of the year till the date of sale.

Depreciation is charged on a uniform basis every year till the asset is written off. The formula is:

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

$$\text{Percentage of Depreciation} = \frac{\text{Depreciation on Original Cost of Asset}}{\text{Original Cost of Asset}} \times 100$$

Advantages

- (a) It is a simple and easy method.
- (b) The value of the asset can be written off, i.e. the value can be reduced to zero.
- (c) This method can be applied where assets get depreciated since with effluxion of time e.g. furniture, equipments, patents, leasehold etc.
- (d) There is no change either in the rate or amount of depreciation over the useful life of the asset.
- (e) The value of the asset each year in the balance sheet is reasonably fair.

Disadvantages:

- (a) The assumption that the asset shall be equally useful through out its life seems to be illogical.
- (b) It does not take into account the effective utilisation of the asset.
- (c) Even though the asset is used uniformly from period to period, the total charge for the use of the asset keeps on increasing every year. This is because cost of repairs in each subsequent year rises though equal amount of depreciation is written off every year.

Illustration 1 :

A firm acquired a machinery on 1st July 2004 at a cost of Rs. 45,000 and spent Rs. 5,000 for its installation. The firm writes off depreciation at 10% per annum on the original cost every year. The books are closed on 31st March every year. Show Machinery Account and Depreciation Account for three years.

Solution:

Machinery Account					
Dr.			Cr.		
Rs.			Rs.		
2004		2005			
Jul. 1	To Bank	45,000	Mar. 31	By Depreciation A/c (10% on Rs. 50,000 for 9 months)	3,750
	To Bank (installation expenses)	5,000		By Balance c/d	46,250
		<u>50,000</u>			<u>50,000</u>
2005		2006			
Apr. 1	To Balance b/d	46,250	Mar. 31	By Depreciation A/c (10% on	

						Rs. 50,000)	5,000
				By		Balance c/d	<u>41,250</u>
			<u>46,250</u>				<u>46,250</u>
2006				2007			
Apr. 1	To	Balance b/d	41,250	Mar. 31	By	Depreciation A/c (10% on Rs. 50,000)	5,000
					By	Balance c/d	<u>36,250</u>
			<u>41,250</u>				<u>41,250</u>
2007							
Apr. 1	To	Balance b/d	36,250				

Depreciation Account							
Dr.				Cr.			
Rs.				Rs.			
2005				2005			
Mar. 31	To	Machinery A/c	<u>3,750</u>	Mar. 31	By	Profit & Loss A/c	<u>3,750</u>
2006				2006			
Mar. 31	To	Machinery A/c	<u>5,000</u>	Mar. 31	By	Profit & Loss A/c	<u>5,000</u>
2007				2007			
Mar. 31	To	Machinery A/c	<u>5,000</u>	Mar. 31	By	Profit & Loss A/c	<u>5,000</u>

(ii) *Depletion Method* : This method is applicable in case of wasting assets, e.g. mines, quarries, oil well etc. from which a certain quantity of output is expected to be obtained. Under this, depreciation is charged on the basis of output extracted in comparison with the estimated total contents of mine. The total cost of mine is divided by the total units of contents in order to find out the rate of depreciation. The quantity extracted during the year is multiplied with rate of depreciation in order to calculate the depreciation for a particular year.

Advantage :

It relates depreciation with the use of the asset.

Disadvantage :

It is difficult to estimate the output correctly.

(iii) *Machine Hour Rate Method (Service Hours Method)* : Machine hour rate is computed by dividing the depreciable amount(original cost less the residual value) by the useful life of the asset expressed in terms of machine hours. In order to calculate the depreciation, the actual number of hours in a particular year is multiplied with the hourly rate. Depreciation can be charged on plant, machinery, vehicles etc. on the basis of this method:

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

Advantage :

Depreciation is related to actual working time of the asset.

Disadvantage :

This method can be used only when the life of the asset can be measured in terms of hours.

B. Declining charge depreciation methods

The amount of depreciation charged decreases for each subsequent year of the assets' life. This method can be applied when

- (a) the asset becomes old and receipts decline.
- (b) it is necessary to charge depreciation according to the asset's expected earnings.

The following three methods fall in this category.

(i) *Diminishing Balance Method (Reducing Balance Method)* : Under this method, depreciation is calculated at a certain percentage each year on the balance of the asset which is brought forward from the previous year. The amount of depreciation charged on each period is not fixed but it goes on decreasing gradually as the beginning balance of the asset in each year will reduce. Thus, amount of depreciation becomes higher at the earlier periods and becomes gradually lower in subsequent periods, when repairs and maintenance charges increase gradually.

$$\text{The formula is : } 1 - \sqrt[n]{\frac{\text{Net Residual Value}}{\text{Cost of Acquisition}}}$$

$$\text{Rate of Depreciation} = 1 - n$$

Where, n = life of the asset in years.

Advantages :

- (a) It is a simple and easy method.
- (b) Every year, there is an equal burden for using the assets. This is because depreciation goes on decreasing every year whereas cost of repairs increases.
- (c) The obsolescence problem is given due care since major part of the depreciation is charged in earlier years and the management may find it easy to replace the asset.
- (d) Income tax authorities recognise this method.
- (e) All items including additions are added together and depreciated at the same rate.

Disadvantages :

- (a) It is difficult to determine an appropriate rate of depreciation.
- (b) The value of the asset cannot be brought down to zero.
- (c) Depreciation is neither based on the use of the asset nor distributed evenly through out the useful life of the asset.

Illustration 2 :

A firm acquired machinery on 1st July 2004 at a cost of Rs. 45,000 and spent Rs. 5,000 for its installation. The firm writes off depreciation at 10% per annum on diminishing balance method . The books are closed on 31st March every year. Show Machinery Account and Depreciation Account for three years.

Solution :

Machinery Account

<i>Dr.</i>			<i>Cr.</i>		
		<i>Rs.</i>			<i>Rs.</i>
2004 Jul. 1	To Bank	45,000	2005 Mar. 31	By Depreciation A/c (10% on Rs. 50,000 for 9 months)	3,750
	To Bank (installation expenses)	<u>5,000</u>		By Balance c/d	46,250
		<u>50,000</u>			<u>50,000</u>
2005 Apr. 1	To Balance b/d	46,250	2006 Mar. 31	By Depreciation A/c (10% on Rs. 46,250)	4,625
	_____	<u>46,250</u>		By Balance c/d	<u>41,625</u>
					<u>46,250</u>
2006 Apr. 1	To Balance b/d	41,625	2007 Mar. 31	By Depreciation A/c (10% on Rs. 41,625)	4,163
		<u>41,625</u>		By Balance c/d	<u>37,462</u>
					<u>41,625</u>
2007 Apr.1	To Balance b/d	37,462			

Depreciation Account					
<i>Dr.</i>			<i>Cr.</i>		
		<i>Rs.</i>			<i>Rs.</i>
2005 Mar. 31	To Machinery A/c	<u>3,750</u>	2005 Mar. 31	By Profit & Loss A/c	<u>3,750</u>
2006 Mar. 31	To Machinery A/c	<u>4,625</u>	2006 Mar. 31	By Profit & Loss A/c	<u>4,625</u>
2007 Mar. 31	To Machinery A/c	<u>4,163</u>	2007 Mar. 31	By Profit & Loss A/c	<u>4,163</u>

Distinction between Straight Line Method and Diminishing Balance Method of depreciation :

<i>Straight Line Method</i>	<i>Diminishing Balance Method</i>
i. Depreciation is charged at a fixed rate on the original cost of the asset.	Depreciation is charged at a fixed rate on the original cost in the first year and on the written down value (cost-minus total depreciation) in the subsequent years.

ii. The amount of depreciation remains the same in all the years of useful life of the asset.	The amount of depreciation goes on decreasing year after year.
iii. The total burden on the profit and loss account is more in the later years because the repair charges increase while the amount of depreciation remains the same.	The total burden on the profit and loss account is almost same in the early years as well as in the later years because of more depreciation plus repairs cost in the beginning and less depreciation plus more repairs cost in the later years.
iv. The book value of the asset becomes zero or equal to scrap value.	The book value never becomes zero.
v. It is easy to calculate the rate of depreciation.	It requires the use of mathematical tables.
vi. It is suitable where repair charges are less and obsolescence is not frequent.	It is suited where repair charges are more in later years and also obsolescence.

(ii) *Sum of Years' Digits Method*: In this method the charge for depreciation for an accounting period is calculated in proportion of the remaining life of the asset at the beginning of every accounting period. The rate of depreciation is determined by the fraction where denominator is the sum of the digits representing the life of the asset and the numerators are individual digits used in the life of asset taken in reverse order.

Depreciation goes on decreasing every year. The formula is:

$$\frac{\text{Remaining life of the asset (taking into account the current year)}}{\text{Sum of the digits of the life of the Asset in years}} \times \text{Cost of Acquiring the Assets}$$

(iii) *Double Declining Balance Method*: This method is similar to reducing balance method explained above except the rate of depreciation is double the straight line rate. Allowance for scrap value of the asset should not be allowed.

Advantages:

- The total cost of the asset is evenly spread over the economic life of the asset and such annual charges includes cost of depreciation and repairs.
- Initially the depreciation charged is more compared to subsequent years. This is advantageous since there is considerable tax saving, demand for funds in the initial year is more and money at present is more beneficial than money in future.

C. Other Methods

(i) *Group Depreciation Method*: Assets having same average life expectancy are grouped together. Depreciation is not charged for each item but is charged for the group as a whole.

(ii) *Inventory System of Depreciation*: In case of assets of small value, the life of the asset cannot be accurately determined, e.g., loose tools, cattle etc.

Depreciation in this case will be calculated as follows:

Value of assets at the beginning of the year	—
Add : Additions during year	—
Total	—
Less : Value of assets at the end of the year	—
Therefore, depreciation for the year	—

(iii) *Depreciation Fund (Sinking Fund) Method*: Under depreciation fund method of providing

depreciation, funds are made available for the replacement of asset at the end of its useful life. The depreciation amount is fixed and remains the same year after year and is charged to profit and loss account every year through the creation of depreciation fund or sinking fund. The amount of annual depreciation is invested outside the business every year in good securities bearing interest at a specified rate. The aggregate amount of interest and annual provision is invested every year. When the asset is completely written off or is to be replaced, the securities are sold and money realised by selling securities is used to replace old asset. Depreciation fund account is closed by transfer of its balance to old asset account.

The journal entries are follows:

(a) At the end of first year:

- (i) For setting aside the amount of depreciation:

Depreciation A/c	Dr.	
To Depreciation Fund A/c		(with the instalment calculated with the help of Sinking Fund Tables)
- (ii) For investing the amount of depreciation:

Depreciation Fund Investment A/c	Dr.	
To Bank		

The depreciation account, of course, goes to the debit of Profit and Loss Account. The Depreciation Fund Account and Depreciation Fund Investments Account are balanced and are shown in the Balance Sheet, the former on the liabilities side and the latter on the assets side.

(b) In the second and subsequent years:

- (i) For interest received on investments

Bank	Dr.	
To Interest on Depreciation Fund Investment A/c		
- (ii) For transferring interest to Depreciation Fund Account

Interest on Depreciation Fund Investment A/c	Dr.	
To Depreciation Fund A/c		

Note : The above two entries may be combined as follows:

Bank	Dr.	
To Depreciation Fund A/c		

- (iii) For annual instalment of depreciation:

Depreciation A/c	Dr.	
To Depreciation Fund A/c		
- (iv) For investing the amount of depreciation and interest received on investment:

Depreciation Fund Investment A/c	Dr.	
To Bank		

(c) At the end of the last year:

In the last year, interest is received on investments and annual instalment of depreciation is transferred to Depreciation Fund Account as usual. But the amount is not invested because at the end of the last year, old asset is replaced by new one which will necessitate the selling of all investments. Therefore in the last year entries Nos. (i), (ii) and (iii) are repeated. Thereafter, the

following additional entries are passed.

(i) For sale of investments:

Bank	Dr.
To Depreciation Fund	
Investment A/c	

(ii) For transfer of profit or loss on sale of investments:

In case of profit -

Depreciation Fund Investment A/c	Dr.	(with the net profit on sale of investment)
To Depreciation Fund A/c		

In case of loss -

Depreciation Fund A/c	Dr.	(with the net loss on sale of investment)
To Depreciation Fund Investment A/c		

(iii) Bank

	Dr.	
To Old Asset A/c		(with the net amount realised on sale)

(iv) For transferring Depreciation Fund Account to Old Asset Account:

Depreciation Fund A/c	Dr.	(with the balance of depreciation fund account)
To Old Asset A/c		

(v) The balance in the Old Assets Account represents profit or loss. It will be transferred to the Profit and Loss Account.

(vi) For purchase of new asset:

New Asset A/c	Dr.
To Bank	

Advantage :

A separate sum is provided for replacing the assets.

Disadvantage:

There is a fixed charge for depreciation. Moreover, the charge for repairs increases every year. Hence the profit and loss account is unduly burdened in later years.

Illustration 3 :

A company purchased 3 years lease on 1st April, 2004 for Rs. 50,000. It is decided to provide for the replacement of the lease at the end of 3 years by setting-up a depreciation fund. It is expected that investment will fetch at 12%. Sinking fund tables shows that Rs. 0.296349 invested each year will produce Re. 1 at the end of 3 years at 12% per annum. The investments are sold for Rs. 28,500.

Give Lease Account, Depreciation Fund Account and Depreciation Fund Investments Account.

Solution:

Annual Depreciation = Rs. 50,000 × 0.296349 = Rs. 14,817.45

Lease Account			
Dr.			Cr.
	Rs.		Rs.
2004		2005	

Apr. 1	To Bank A/c	<u>50,000</u>	Mar. 31	By Balance c/d	<u>50,000</u>
2005			2006		
Apr. 1	To Balance b/d	<u>50,000</u>	Mar. 31	By Balance c/d	<u>50,000</u>
2006			2007		
Apr. 1	To Balance b/d	50,000	Mar. 31	By Depreciation Fund A/c	47,088
				By Profit & Loss A/c	<u>2,912</u>
		<u>50,000</u>			<u>50,000</u>

Depreciation Fund Account

2005			2005		
Mar. 31	To Balance c/d	14,817.45	Mar. 31	By Depreciation A/c	14,817.45
2006			2005		
Mar. 31	To Balance c/d	31,412.94	Apr. 1	By Balance b/d	14,817.45
			2006		
			Mar. 31	By Depreciation A/c	14,817.45
				By Interest on D.F. Investment A/c	<u>1,778.04</u>
		<u>31,412.94</u>			<u>31,412.94</u>
2007			2006		
Mar. 31	To Depreciation Fund Investment A/c	2,912.00	Apr. 1	By Balance b/d	31,412.94
" "	To Lease Account	47,088.00	2007		
			Mar. 31	By Depreciation A/c	14,817.62
				By Interest on D.F. Investment A/c	<u>3,769.44</u>
		<u>50,000.00</u>			<u>50,000.00</u>

Depreciation Fund Investment Account

2005			2005		
Mar. 31	To Bank	<u>14,817</u>	Mar. 31	By Balance c/d	<u>14,817</u>
2005					
Apr. 1	To Balance b/d	14,817			
2006			2006		
Mar. 31	To Bank A/c	<u>16,595</u>	Mar. 31	By Balance c/d	<u>31,412</u>
		<u>31,412</u>			<u>31,412</u>
2006			2007		
Apr. 1	To Balance b/d	31,412	Mar. 31	By Bank	28,500
			" "	By Depreciation Fund A/c	<u>2,912</u>
		<u>31,412</u>			<u>31,412</u>

Illustration 4

On July, 2003, Glory Ltd., purchased a machine for Rs. 1,10,000 and spent Rs. 6,000 on its installation. The expected life of the machine is 4 years at the end of which the estimated scrap value will be Rs. 16,000. Desiring to replace the machine on the expiry of its life, the company establishes a sinking fund. Investments are expected to realise 12% interest.

On 30th June, 2007, the machine was sold off as scrap for Rs. 18,000 and the investments were realised at 5% less than the book value. On 1st July, 2007, a new machine was installed at a cost of Rs. 1,25,000. Sinking fund tables show that Re. 0.2092 invested each year will produce Re. 1 at the end of 4 years at 12%. Show the necessary ledger accounts in the books of Glory Ltd. for all the years.

Solution:

Machine Account					
Dr.			Cr.		
<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>
2003			2004		
July 1	To Bank (purchases)	1,10,000	June 30	By Balance c/d	1,16,000
	To Bank (installation charges)	6,000			
		<u>1,16,000</u>			<u>1,16,000</u>
2004			2005		
July 1	To Balance b/d	1,16,000	June 30	By Balance c/d	1,16,000
		<u>1,16,000</u>			<u>1,16,000</u>
2005			2006		
July 1	To Balance b/d	1,16,000	June 30	By Balance c/d	1,16,000
		<u>1,16,000</u>			<u>1,16,000</u>
2006			2007		
July 1	To Balance b/d	1,16,000	June 30	By Bank (sale of scrap)	18,000
		<u>1,16,000</u>		By Sinking Fund A/c	96,470
				By Profit & Loss A/c	1,530
		<u>1,16,000</u>			<u>1,16,000</u>
2007					
July 1	To Bank (installation of a new machine)	1,25,000			

Sinking Fund Account					
<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>
2004			2004		
June 30	To Balance c/d	<u>20,920</u>	June 30	By Depreciation A/c	<u>20,920</u>
		<u>20,920</u>			<u>20,920</u>

<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>
2005 June 30	To Balance c/d	44,350	2004 July 1	By Balance b/d	20,920
			2005 June 30	By Interest on Investment 2,510	
				By Depreciation A/c	<u>20,920</u>
		<u>44,350</u>			<u>44,350</u>
2006 June 30	To Balance c/d	70,592	2005 July 1	By Balance b/d	44,350
			2006 June 30	By Interest on Investment	5,322
				By Depreciation A/c	<u>20,920</u>
		<u>70,592</u>			<u>70,592</u>
2007 June 30	To Sinking Fund Investment A/c (loss on sale)	3,530	2006 July 1	By Balance b/d	70,592
	To Machinery A/c	<u>96,470</u>	2007 June 30	By Interest on Investments	8,471
		<u>1,00,000</u>		By Depreciation A/c	<u>20,937</u>
					<u>1,00,000</u>

Sinking Fund Investment Account

<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>
2004 June 30	To Bank	<u>20,920</u>	2004 June 30	By Balance c/d	<u>20,920</u>
		<u>20,920</u>			<u>20,920</u>
2004 July 1	To Balance b/d	20,920	2005 June 30	By Balance c/d	44,350
2005 June 30	To Bank (Rs. 20,920 + Rs. 2,510)	23,430			
		<u>44,350</u>			<u>44,350</u>
2005 July 1	To Balance b/d	44,350	2006 June 30	By Balance c/d	70,592
2006 June 30	To Bank (Rs. 20,920 + Rs. 5,322)	26,242			
		<u>70,592</u>			<u>70,592</u>
<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>
2006 July 1	To Balance b/d	70,592	2007 June 30	By Bank (Sale - 70,952 less 5%)	67,062
				By Sinking Fund A/c	3,530

70,592

(loss on sale)

70,592

Working Notes:

- (i) Amount required = Rs. 1,10,000 + Rs. 6,000 - Rs. 16,000 = Rs. 1,00,000
- (ii) Annual contribution is therefore Rs. 1,00,000 X Re. 0.2092 = Rs. 20,920
- (iii) Accounting period must be assumed to end on 30th June.
- (iv) In order to make sinking fund at Rs. 1,00,000, the depreciation amount in last year is suitably adjusted.
- (iv) *Insurance Policy Method* : Under this method, the business takes an insurance policy for required amount to replace the asset when it is worn out. A fixed amount of premium is paid every year. However, this amount will have to be paid in the beginning of each year. At the end of the specified period, the insurance company pays the agreed amount with which the new asset can be purchased. The accounting records will be as follows:

(a) First year and subsequent years:

In the beginning of the year for insurance premium paid:

Depreciation Insurance Policy A/c Dr.
 To Bank

At the end of the year:

Profit and Loss A/c Dr.
 To Depreciation Reserve A/c

(b) At the end of the last year :

On realisation of money from the insurance company:

Bank Dr.
 To Depreciation Insurance Policy A/c

For transfer of profit on insurance policy:

Depreciation Insurance Policy A/c Dr.
 To Depreciation Reserve A/c

For transfer of accumulated depreciation to the Asset Account:

Depreciation Reserve A/c Dr.
 To Asset A/c

On purchase of new asset :

New Asset A/c Dr.
 To Bank

Illustration 5 :

A firm purchases a lease for 3 for years for Rs. 60,000 on 1.4.2004. It decides to provide for its replacement by means of an insurance policy for Rs. 60,000. The annual premium is Rs. 19,000. On 1.4.2006, the lease is renewed for a further period of 3 years for Rs. 60,000. You are required to show necessary ledger accounts.

Solution:

Lease Account					
Dr.			Cr.		
		Rs.			Rs.
2004			2005		
Apr. 1	To Bank	60,000	Mar. 31	By Balance c/d	60,000
		-----			-----
2005			2006		
Apr. 1	To Balance b/d	60,000	Mar. 31	By Balance c/d	60,000
		-----			-----
2006			2007		
Apr. 1	To Balance b/d	60,000	Mar. 31	By Depreciation Reserve A/c	60,000
		-----			-----

Depreciation Insurance Policy Account					
2004			2005		
		Rs.			Rs.
Apr. 1	To Bank (premium)	<u>19,000</u>	Mar. 31	By Balance c/d	<u>19,000</u>
2005			2006		
Apr. 1	To Balance b/d	19,000	Mar. 31	By Balance c/d	<u>38,000</u>
" "	To Bank	<u>19,000</u>			<u>38,000</u>
		<u>38,000</u>			
2006			2007		
Apr. 1	To Balance b/d	38,000	Mar. 31	By Bank	60,000
" "	To Bank	19,000			
" "	To Depreciation Reserve A/c (profit transferred)	<u>3,000</u>			
		<u>60,000</u>			<u>60,000</u>

Depreciation Reserve Account					
2005			2005		
		Rs.			Rs.
Mar. 31	To Balance c/d	<u>19,000</u>	Mar. 31	By Profit and Loss A/c	<u>19,000</u>
Apr. 1	By Balance b/d	19,000	2006		
2006			2006		
March 31	Balance c/d	<u>38,000</u>	Mar. 31	By Profit and Loss A/c	<u>19,000</u>
		<u>38,000</u>			<u>38,000</u>
2007			2006		
Mar. 31	To Lease A/c	60,000	Apr. 1	By Balance b/d	38,000
			2007		
			Mar. 31	By Profit and Loss A/c	19,000
			" "	By Depreciation Insurance Policy A/c	<u>3,000</u>
		<u>60,000</u>			<u>60,000</u>

Distinction between Sinking Fund and Insurance Policy Methods of Depreciation

- (a) Interest is an integral part of sinking fund method, though it is not considered under insurance policy method.
- (b) Investment in securities is the basic feature of sinking fund method. The money is not invested in any outside securities under insurance policy method. Only an insurance policy is taken for the required amount to replace the asset at the end of the useful life of the asset.
- (c) Under sinking fund method, investments are made at the end of the accounting period. However, premium is paid in advance at the beginning of the year under insurance policy method.
- (d) Under sinking fund method, the amount realised is affected by fluctuations in interest rate and value of securities. But, under insurance policy method, the amount realised at the end of the life of the asset is fixed.
- (v) *Annuity Method* : The annuity method considers that the business besides losing the original cost of the asset also loses interest on the amount used for buying the asset, which would have been earned in case the same amount would have been invested in some other form of investment. Thus, this method takes into account the interest factor. The amount of interest is calculated on the book value of the asset in the beginning of each year. The amount of depreciation is uniform and is determined on the basis of annuity table.

The journal entries under this method are the following:

- (i) On purchase of the asset:

Asset Account	Dr.
To Bank	
- (ii) For charging interest on asset:

Asset Account	Dr.
To Interest Account	
- (iii) For charging depreciation:

Depreciation Account	Dr.
To Asset Account	
- (iv) For transfer of Interest Account to Profit and Loss Account:

Interest Account	Dr.
To Profit and Loss Account	
- (v) For transfer of Depreciation Account to Profit and Loss Account:

Profit and Loss Account	Dr.
To Depreciation Account	

Illustration 6 :

A firm purchased a lease-hold property on 1st April 2002 for 5 years at a cost of Rs. 5,00,000. It decided to write off the lease by annuity method presuming the rate of interest at 14%. The

annuity table shows that annual amount necessary to write off Re. 1 in 5 years at 14% is Rs. 0.291284. Show the lease account for 5 years. Calculations be made to the nearest rupee.

Solution:

Lease Account					
Dr.			Cr.		
Rs.			Rs.		
2002			2003		
Apr. 1	To Bank	5,00,000	Mar. 31	By Depreciation A/c	1,45,642
2003			" "	By Balance c/d	4,24,358
Mar. 31	To Interest A/c (on Rs. 5,00,000)	<u>70,000</u>			
		<u>5,70,000</u>			<u>5,70,000</u>
2003			2004		
Apr. 1	To Balance b/d	4,24,358	Mar. 31	By Depreciation A/c	1,45,642
2004			" "	By Balance c/d	3,38,126
Mar. 31	To Interest A/c (on Rs. 4,24,358)	<u>59,410</u>			
		<u>4,83,768</u>			<u>4,83,768</u>
Rs.			Rs.		
2004			2005		
Apr. 1	To Balance b/d	3,38,126	Mar. 31	By Depreciation A/c	1,45,642
2005			" "	By Balance c/d	2,39,822
Mar. 31	To Interest A/c (on Rs. 3,38,126)	<u>47,338</u>			
		<u>3,85,464</u>			<u>3,85,464</u>
2005			2006		
Apr. 1	To Balance b/d	2,39,822	Mar. 31	By Depreciation A/c	1,45,642
2006			" "	By Balance c/d	1,27,755
Mar. 31	To Interest A/c (on Rs. 2,39,822)	<u>33,575</u>			<u>1,27,755</u>
		<u>2,73,397</u>			<u>2,73,397</u>
2006			2007		
Apr. 1	To Balance b/d	1,27,755	Mar. 31	By Depreciation A/c	1,45,642
2007					
Mar. 31	To Interest	<u>17,887</u>			
		<u>1,45,642</u>			<u>1,45,642</u>

Working Note:

- Amount of depreciation Rs. 5,00,000 × Rs. 0.291284 = Rs. 1,45,642
- The amount of depreciation is fixed for all the years.
- The amount of interest is reduced every year because it is calculated on the written down balance.

Distinction between Sinking Fund and Annuity Methods of Depreciation:

- Under sinking fund method, the annual amount is set aside to a separate fund account. However, the annual amount is not set aside to a separate fund account in annuity method.
- Since annual amount set aside are invested in outside securities, sufficient funds will be

available for replacement of asset under sinking fund method. However, there is no provision of funds at the time of replacement of assets in annuity method.

- (iii) In sinking fund method, as the investment is made at the end of the first year, the first interest is earned only during the second year. In annuity method, interest is assumed to accrue in the first year of purchase of asset, therefore, it is charged from the end of the first year.
- (iv) Under sinking fund method, the total depreciation is less than the asset's depreciable cost due to deduction of interest. However, in annuity method, as the interest is added to the cost of the assets, the total depreciation is more than the depreciable cost of the asset.
- (v) Under sinking fund method, interest is actually realised since it is to be received from investments outside the business. In annuity method, interest is only assumed as against actual receipt.
- (vi) Under sinking fund method, annual net effect on profit and loss account is same because of uniform fixed amount of depreciation. However, in annuity method, annual net effect on profit and loss account increases due to fixed depreciation charge and declining interest.
- (vii) Under sinking fund method, interest realised is credited to sinking fund account, while interest is credited to profit and loss account and debited to asset account in annuity method.

9. CHANGE IN METHOD OF DEPRECIATION

Consistency principle of accounting requires that same accounting practices and methods should be observed and followed from year to year as otherwise the reported profit or loss will not be comparable. Hence, it is expected that the concern should consistently follow the method of depreciation which is once chosen. However, sometimes, a change in the method becomes inevitable. According to Accounting Standard-6 (AS-6) 'Depreciation Accounting', issued by the Institute of Chartered Accountants of India, when a change in the method of depreciation is made, depreciation is re-calculated in accordance with the new method from the date of asset coming into use. In brief change in method is permitted retrospectively, that is, from the date of purchase for existing assets only. Wherein change is to be effective with some back date, first of all, calculate the value of asset by the new method on the date of change. It will become the basis of computation of depreciation for periods after the date of change. Furthermore, in order to adjust depreciation for past periods due to change of method, depreciation is to be calculated for the past period of asset use both by existing as well as by the changed method and the difference is adjusted in the current year's asset account by giving debit or credit to profit and loss account.

If no depreciation is charged, this should be made clear by way of a note which should also state the amount of depreciation that should have been charged. This is necessary to enable people to judge the true profit or loss of the firm.

10. PROFIT OR LOSS ON SALE OF FIXED ASSETS

Assets may be sold or discarded before or on the expiry of its useful life. Then it is necessary to calculate the profit or loss, if any, on such sale. For this purpose the book value of the assets at the date of sale is to be calculated by deducting the total depreciation from the date of purchase to the date of sale from the original cost. If the sale price is more than the book value there is profit on sale of the assets and if the sale price is less than the book value, the difference will be loss on sale. The following journal entries are passed to record the above transactions:

- (i) On sale of assets:

Bank
To Assets Account

Dr.

(with the sale price)

- (ii) Profit on sale of asset:
 Asset Account Dr.
 To Profit and Loss Account

In case of loss the above entry is reversed.

This accounting procedure is adopted when the depreciation is directly credited to the asset account. However, when Provision for Depreciation Account is maintained then the asset account appears at its cost price and the following accounting procedure is followed:

- (i) Transfer of accumulated depreciation including the depreciation created at the time of sale or discardment:
 Provision for Depreciation Account Dr.
 To Asset Account
- (ii) On sale of the asset:
 Bank Dr.
 To Asset Account
- (iii) If the amount of accumulated depreciation and sale price put together is less than the original cost of the asset, the difference is loss on sale and transferred to profit and loss account:
 Profit and Loss Account Dr.
 To Asset Account
- (iv) In case the accumulated depreciation and sale price put together is more than the original cost of the asset, the difference is treated as profit on sale and is credited to profit and loss account:
 Asset Account Dr.
 To Profit and Loss Account

When Provision for Depreciation Account is maintained on sale of asset, alternatively, it is suggested to open an 'Asset Disposal Account' in such case the following accounting entries may be passed:

- (i) On transfer of original cost of asset to Asset Disposal Account:
 Asset Disposal Account Dr.
 To Asset Account
- (ii) On sale of the asset:
 Bank Dr.
 To Asset Disposal Account
- (iii) On transfer of Provision for Depreciation Account to Asset Disposal Account:
 Provision for Depreciation Account Dr.
 To Asset Disposal Account
- (iv) For profit on disposal of asset:
 Asset Disposal Account Dr.
 To Profit and Loss Account

In case of loss the above entry is reversed.

11. LOSS BY ACCIDENT AND INSURANCE CLAIM

In case some assets have been destroyed either by accident or fire and such assets had been insured against such loss, the firm may file a claim with the insurance company. The following accounting procedure is followed:

- (i) On admission of claim:
 Insurance Company Dr.
 To Asset Account
- (ii) On receipt of money claimed:

Bank Dr.
To Insurance Company

In case the insurance claim is received immediately, then:

Bank Dr.
To Asset Account

The difference in the book value of asset on the date of account and the amount of claim admitted by the insurance company is transferred to profit and loss account i.e. in case of loss, the entry will be:

Profit and Loss Account Dr.
To Asset Account

Illustration 7

M Ltd. which depreciates its machinery @ 10% per annum according to diminishing balance method, had on 1st April, 2006 Rs. 4,86,000 balance in its machinery account. During the year ended 31st March, 2007, the machinery purchased on 1st April, 2004 for Rs. 60,000 was sold for Rs. 40,000 on 1st October, 2006 and a new machinery costing Rs. 70,000 was purchased and installed on the same date; installation charges being Rs. 5,000.

The company wants to change its method of depreciation from diminishing balance method to straight line method w.e.f. 1st April, 2004 and adjust the difference before 31st March, 2007, the rate of depreciation remaining the same as before.

Show the machinery account for the year ended 31st March, 2007.

Solution:

Machinery Account							
Dr.				Cr.			
2006		Rs. 2006				Rs.	
Apr. 1	To Balance b/d	4,86,000	Oct. 1	By Bank		40,000	
Oct. 1	To Bank (cost and installation charges)	75,000		By Profit and Loss A/c (loss on sale of machinery)		6,170	
				2007			
				Mar. 31	By Depreciation A/c	60,180	
					By Profit and Loss A/c (Addl. depreciation)	5,400	
					By Balance c/d	4,49,250	
		5,61,000				5,61,000	

Working Notes:

	Rs.
(1) <i>Calculation of loss on sale of machinery:</i>	
Cost of machinery on April 1, 2004	60,000
Less: Depreciation for 2004-05	6,000

	54,000
Less: Depreciation for 2005-06	5,400

	48,600
Less: Depreciation for half year	2,430
Book value as on 1st October, 2006	46,170
Less: Amount realised from sale	40,000

Loss on sale	6,170

(2) *Additional depreciation:*

Cost of machinery on 1st April, 2004

$$= 4,86,000 \times \frac{100}{90} \times \frac{100}{90} = \text{Rs. } 6,00,000$$

Book value on 1st April, 2004

for machinery sold in 2006 = Rs. 60,000

Book value on 1st April, 2004 on original group 5,40,000

Depreciation for 2 years (2004-05 and 2005-06)

@ 10% on Rs. 5,40,000 1,08,000

Less: Depreciation provided for 2 years under
diminishing balance method (Rs. 54,000 + Rs.48,600)

1,02,600

Additional depreciation due to change in the system
charged to profit and loss account

5,400

(3) *Depreciation for 2006-07*

Rs.

On machinery sold

2,430

On machinery purchased and installed

3,750

On machinery brought from previous year

(i.e. on Rs. 5,40,000 on straight line method)

54,000

60,180

Illustration 8

On 1st April, 2004, a firm purchased a machinery for Rs. 2,00,000. On 1st October in the same accounting year, additional machinery costing Rs. 1,00,000 was purchased. On 1st October, 2005, the machinery purchased on 1st April, 2004, having become obsolete, was sold off for Rs. 90,000. On 1st October, 2006, new machinery was purchased for Rs. 2, 50,000 while the machinery purchased on 1st October, 2004 was sold for Rs. 85,000 on the same day.

The firm provides depreciation on its machinery @ 10% per annum on original cost on 31st March every year.

Show machinery account, provision for depreciation account and depreciation account for the period of three accounting years ending 31st March, 2007.

Solution:

Machinery Account

Dr.					Cr.
2004		Rs.	2005		Rs.
Apr. 1	To Bank	2,00,000	Mar. 31	By Balance c/d	3,00,000

Oct. 1	To Bank	<u>1,00,000</u>				<u>3,00,000</u>
		3,00,000				3,00,000
2005			2005			
Apr. 1	To Balance b/d	3,00,000	Oct. 1	By Bank	90,000	
				By Provision for Depreciation A/c	30,000	
				By Profit and Loss A/c	80,000	
			2006			
			Mar. 31	By Balance c/d	<u>1,00,000</u>	
		<u>3,00,000</u>			3,00,000	
2006			2006			
Apr. 1	To Balance b/d	1,00,000	Oct. 1	By Bank	85,000	
Oct. 1	To Bank	2,50,000		By Provision for Depreciation A/c	20,000	
	To Profit and Loss A/c	5,000				
			2007			
			Mar. 31	By Balance c/d	<u>2,50,000</u>	
		<u>3,55,000</u>			3,55,000	

Depreciation Account						
Dr.			Cr.			
2005		Rs.	2005		Rs.	
Mar. 31	To Provision for Depreciation A/c	25,000	Mar. 31	By Profit and Loss A/c	25,000	
		<u>25,000</u>			<u>25,000</u>	
2005			2006			
Oct. 1	To Provision for Depreciation A/c	10,000	Mar. 31	By Profit and Loss A/c	20,000	
		Rs.			Rs.	
2006						
Mar. 31	To Provision for Depreciation A/c	10,000				
		<u>20,000</u>			<u>20,000</u>	
2006			2007			
Oct. 1	To Provision for Depreciation A/c	5,000	Mar. 31	By Profit and Loss A/c	17,500	
2007						
Mar. 31	To Provision for Depreciation A/c	12,500				
		<u>17,500</u>			<u>17,500</u>	

Provision for Depreciation Account						
2005		Rs.	2005		Rs.	
Mar. 31	To Balance c/d	25,000	Mar. 31	By Depreciation A/c (20,000 + 5,000)	25,000	
		<u>25,000</u>			<u>25,000</u>	

		25,000			25,000
2005			2005		
Oct. 1	To Machinery A/c		Apr. 1	By Balance b/d	25,000
	(20,000 + 10,000)	30,000	Oct. 1	By Depreciation A/c	10,000
2006			2006		
Mar. 31	To Balance c/d	15,000	Mar. 31	By Depreciation A/c	10,000
		45,000			45,000
2006			2006		
Oct. 1	To Machinery A/c		Apr. 1	By Balance b/d	15,000
	(5,000+10,000		Oct. 1	By Depreciation A/c	5,000
	+5,000)	20,000			
2007			2007		
Mar. 31	To Balance c/d	12,500	Mar. 31	By Depreciation A/c	12,500
		32,500			32,500
			2007		
			Apr. 1	By Balance b/d	12,500

12. DEPRECIATION AND REPLACEMENT OF ASSETS

In the context of present inflationary conditions, it will be appropriate to provide for depreciation on the replacement cost instead of on the historical cost. This is because of the fact that depreciation is provided for replacing an asset. Sufficient funds will not be available for replacing an asset at the end of its serviceable life, if depreciation is provided on the basis of historical cost, due to the substantial increase in the cost of the new asset to replace an old asset. The following difficulties may crop up when replacement cost system is used:

- Estimating replacement cost in advance is difficult.
- The method of charging depreciation on the basis of replacement cost is not recognised by income tax authorities.
- The method of charging depreciation on replacement cost during inflationary conditions is preferred but not during period of falling prices.
- According to the Companies Act, depreciation should be charged on the original cost of the asset and any deficiency or surplus arising due to sale of such asset should be transferred to the profit and loss account.
- Any new asset purchased, with few exceptions, is always of a better quality than the asset replaced. Hence, it is difficult to calculate the cost of the asset replaced.

These difficulties can be obviated by taking the following steps:

- The additional amount required for replacing the asset over and above the original cost of the asset may be estimated. Every year, an appropriate amount may be transferred from Profit and Loss Account besides usual depreciation on asset to provide for additional amount required for replacement of the asset over and above the original cost of the asset. It may be debited to Profit and Loss Appropriation Account and credited to Replacement Reserve account.
- The Replacement Reserve Account should be credited every year with interest at the current rate on the accumulated balance standing on the credit of the account.

SELF-TEST QUESTIONS

- Why is correct calculation of depreciation necessary?

2. What are the methods of providing depreciation?
3. Discuss the various factors which are considered for calculating depreciation.
4. What are the various causes of depreciation on fixed assets?
5. Distinguish between straight line and diminishing balance methods of depreciation.
6. What do you mean by replacement cost? What are the difficulties faced while providing for depreciation on the basis of replacement cost?
7. Distinguish between sinking fund and annuity methods of depreciation.
8. "Depreciation is a process of allocation and not of valuation". Comment.
9. Deva Ltd. charges depreciation on its plant and machinery @10% per annum on the diminishing balance method. On 31st March, 2007, the company decides to adopt straight line method of charging depreciation with retrospective effect from 1st April, 2003, the rate of depreciation being 15%. On 1st April, 2006, the plant and machinery account stood in the books at Rs. 2,91,600. On 1st July, 2006, a sum of Rs. 65,000 was realised by selling a machine cost of which on 1st April, 2003 was Rs. 90,000. On 1st January, 2007, a new machine was acquired at a cost of Rs. 1,50,000.

Show the plant and machinery account in the books of the company for the year ended 31st March, 2007.

10. A firm acquired a machine for Rs. 5,00,000 on 1.4.2004. Depreciation was to be charged at 20% on straight line method. During 2006-07, a modification was made to improve its technical reliability at a cost of Rs. 50,000 which it was considered would extend the useful life of machine for 2 years. At the same time one important component of the machine was replaced at a cost of Rs. 10,000 because of excess wear and tear.

Routine maintenance during the said accounting period cost Rs. 7,500. Show the machine account, provision for depreciation on machine account and charge to profit and loss account for the year ending 31st March, 2007.

Suggested Readings :

- (1) *J.R. Monga* — Advanced Financial Accounting
 - (2) *M.C. Shukla, T.S. Grewal and S.C. Gupta* — Advanced Accounts, Vol. I
 - (3) *S.N. Maheshwari* — Financial Accounting
 - (4) *S.P. Jain and K.L. Narang* — Financial Accounting
-

STUDY VII

ACCOUNTING FOR BILLS OF EXCHANGE

1. INTRODUCTION

In the modern business world goods are sold on cash as well as on credit basis. When goods are sold on credit basis payment is made either in lump sum on the expiry of a certain period or in

instalments after specified intervals. In such cases, there is a possibility that a purchaser (debtor) may not make payment on the specified date and hence the same will lead to a clash. Moreover, the seller (creditor) has to wait for the payment till the agreed period. In order to overcome this situation, the seller is generally prepared to grant credit to the purchaser provided he gives a definite promise in writing to pay the amount of goods after the specified period. In business circle there developed a system by which written documents in the form of agreements are obtained from debtors in evidence of the transaction. Such documents are known as instruments of credit e.g.; bills of exchange, promissory notes, hundies etc. The main feature about these instruments of credit is that they enable the buyer to accept the undertaking to pay a fixed sum of money with or without interest at a fixed date in the future. The seller can discount the bill of exchange or promissory note with a bank and obtain cash for which he would otherwise have to wait till the expiry of the credit period.

2. BILLS OF EXCHANGE

A bill of exchange is an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument. The person who thus orders payment is called drawer, the person to whom the order is given is called the drawee and the person to whom the payment has to be made is called payee. Drawer and payee may be the same person. Drawee becomes bound to pay only when he has signified his acceptance of the order in writing on the face of the order itself. After such acceptance, drawee is called as acceptor also.

Rs. 10,000 Stamp Three months after the date pay to Shri Murli Dhar or order the sum of Rupees Ten Thousand only, for value received. (Sd.) B.M. Bhatia To Mr. Manik Verma Chandni Chowk Delhi 110 006.	Delhi 11th March, 2007
---	-----------------------------------

the payee. The draft will be sent by B.M. Bhatia to Manik Verma. If it is acceptable to the latter, he will signify his acceptance across the draft as follows:

Accepted
Manik Verma
(Signed)

Acceptance will convert the draft into a valid bill of exchange for which Manik Verma will be bound to pay. Manik Verma return the document to B.M. Bhatia.

A bill of exchange which is not inland is known as foreign bill of exchange. Such a bill is generally drawn up in triplicate. Each copy reaches the intended party. Of course, payment will be made only on one of the copies and when such payment has been made the other copies become useless.

Following is the specimen of one of the copies of a foreign bill of exchange:

\$.10,000	New Delhi, 11th March, 2007
---	--

Stamp

Ninety days after sight of this first bill of exchange (second and third of the same tenor and date being unpaid) pay to M/s Black & White, New York or order the sum of Ten Thousand dollars only for value received.

(Sd.) W. Taylor

To
Mr. Charles Smith,
New York

Following are examples of foreign bill:

1. A bill drawn in India on a person resident outside India and made payable outside India.
2. A bill drawn outside India on a person resident outside India.
3. A bill drawn outside India and made payable in India.
4. A bill drawn outside India and made payable outside India.

The essential elements of a bill of exchange can be summarized as under:

- (i) *Date* : The drawer must mention the date on the face of the bill. The date is important because the period of the bill will be counted from this date.
- (ii) *Time* : It is the period after which the drawee must make payment of the amount stated in the bill so that there is no dispute later on.
- (iii) *Amount* : The amount payable must be stated both in figures and words to avoid the possibility any alteration.
- (iv) *Parties* : There are three parties to a bill of exchange, namely the drawer, the drawee and the payee. The drawer is the person who draws the bill on another person. He is the creditor and draws the bill on his debtor. The drawee is the person on whom the bill is drawn and the drawee gives his acceptance by writing the word 'accepted' and putting his signature and the date, and he becomes the acceptor of the bill. The payee is the person in whose favour the amount of the bill is made payable. In other words payee is the person to whom the payment of the bill is to be made on due date. Sometimes the drawer and payee may be the same person and in such case there will be only two parties in the bill.
- (v) *Stamp* : Stamp has to be affixed on every bill of exchange except a bill payable on demand. The value of the stamp depends on the amount of the bill.
- (vi) *For value received* : The last words in the description of the bill of exchange, "value received" indicate that the bill is being drawn by the drawer on the drawee in consideration of the goods sold to the drawee on credit.
- (vii) *Acceptance* : A bill of exchange must be accepted by the drawee to make it a legal document.

3. FEATURES OF BILL OF EXCHANGE

A bill of exchange to be valid must possess the following features:

- (i) It must be in writing.
- (ii) It must contain an order to pay which is express and unconditional.
- (iii) It must be signed by the drawer.
- (iv) The drawer, drawee and payee must be certain, definite and individuals.
- (v) The amount of money to be paid must be certain.
- (vi) The money must be made payable to a definite person or according to his order or to the bearer of the bill after a definite period of time.
- (vii) The bill must be accepted by the party on whom the order is drawn and addressed.
- (viii) It must be properly stamped and dated.

4. ADVANTAGES OF BILLS OF EXCHANGE

- (i) An accepted bill of exchange is a written and signed acknowledgement of debt and it affords conclusive proof of indebtedness.
- (ii) Payment can be enforced on a bill of exchange in a court of law.
- (iii) It fixes the date of payment with the result that the creditor knows in no uncertain terms as to when he will get the payment and the debtor also knows when he is to pay definitely. The debtor and creditor can plan the utilisation of their financial resources in a systematic manner.
- (iv) The debtor enjoys the full period of credit. He can never be called upon to pay the amount of the bill before the due date.
- (v) A bill gives the creditor an option either to wait for receipt of money till due date or get cash immediately by discounting it with his bank. He need not lock up his money until date of maturity.
- (vi) It is a negotiable instrument and can be transferred from hand to hand in settlement of debts.
- (vii) A bill of exchange is a simple and convenient means of transferring money from one place to another. It avoids the risks of carrying the currency to different places of trade.
- (viii) Accommodation bills enable the businessmen to obtain funds from the market at cheap rates to meet their temporary financial requirements.

5. PROMISSORY NOTE

A promissory note is an instrument in writing, not being a bank note or a currency note containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of certain person. Under Section 31(2) of the Reserve bank of India Act, a promissory note cannot be made payable to bearer. A promissory note has two parties - maker and payee. Maker is the person who makes the promissory note whereas the person to whom the amount of the promissory note is payable is called the payee.

Following is the specimen of a promissory note:	
	New Delhi 18th June, 2007
Rs. 25,000	
Two months after date, we promise to pay Shri Devi Dayal or order the sum of Rupees Twenty Five Thousand only for value received.	
	Stamp
	For M/s Harmeet Singh Balbir Singh Harmeet Singh (signed) Partner

A promissory note must be in writing. It must contain a clear promise to pay; mere acknowledgement of a debt is not a promise to pay. The promise to pay must be unconditional (A promise to pay "as soon as possible" is not considered as a promise). The promisor, i.e., the maker of the promissory note, must sign the promissory note. Maker must be a certain person. The payee, i.e., the person to whom the payment is promised must also be certain person. The sum payable must be certain (Promise to pay say "Rs. 1,000 plus all fines" is not a promise to pay a certain sum of money). Promissory note must not be payable to bearer. It must be properly stamped.

6. DISTINCTION BETWEEN BILLS OF EXCHANGE AND PROMISSORY NOTE

The following points of distinction between a bill of exchange and a promissory note may be noted:

1. In a bill, there are three parties namely drawer, drawee, and payee. In a promissory note there are two parties viz. maker and payee.
2. In a bill the drawer and payee may be the same person but in a promissory note, maker cannot be the payee.
3. In a bill there is an unconditional order to drawee to pay according to the drawer's direction while a promissory note contains an unconditional promise by the maker to pay to the payee or to his order.
4. A bill payable after sight must be accepted by the drawee or someone else on his behalf before it can be presented for payment. A promissory note is presented for payment without any prior acceptance by the maker.
5. The liability of a maker of a promissory note is primary and absolute and the liability of the drawer of a bill is secondary and conditional.
6. The maker of a promissory note stands in immediate relation with the payee, while the drawer of an accepted bill stands in immediate relation with the acceptor and not the payee.

7. BILLS RECEIVABLE AND BILLS PAYABLE

Bills of exchange and promissory notes for which a firm has for the time being the right to receive payment by virtue of being the payee or the endorsee of the same are called bills receivable. On the other hand, bills of exchange and promissory notes on which the firm is liable to pay because it is the acceptor of bills of exchange and maker of the promissory notes are called bills payable for the firm. The effect of acceptance of a bill of exchange and that of making of a promissory note is the same.

Where transactions relating to bills are not large in number, they are recorded in journal itself. Whenever a bill receivable is received, the following journal entry is passed with the amount of the bill:

Bills Receivable Account	Dr.	with the amount of the bill
To Acceptor of Bill of Exchange/ Maker of Promissory Note		

The party accepting the bill of exchange or making of the promissory note passes the following journal entry:

Drawer of Bills of Exchange/ Payee of Promissory Note	Dr.	with the amount of the bill
To Bills Payable Account		

It is clear that the acceptance of a bill of exchange or making of a promissory note is considered as equivalent of payment for debt. Of course, in place of the original debt, a liability on bills payable arises.

Similarly, for a bills receivable credit is given to acceptor of bill of exchange or maker of the promissory note as if cash were received from such acceptor or maker. bills receivable account shows debit balance and appears on the assets side of the balance sheet. Bills payable account shows credit balance and appears on the liabilities side of the balance sheet.

8. BILLS RECEIVABLE AND BILLS PAYABLE BOOKS

When entries for bills receivable and bills payable are recorded in journal, memoranda record has to be maintained of the names of the parties who have drawn bills or accepted bills, the amounts of such bills and their respective due dates. However, when the bill transactions are large in number special subsidiary books are maintained to record receipt of bills receivable and issue of bills payable. Bills Receivable Book records the receipts of bills receivable while Bills Payable Book records the issues of bills payable.

Illustration 1 :

Prepare Bills Receivable Book and Bills Payable Book form the following:

2007

- July 2 Sent a promissory note dated this day at 3 months for Rs. 1,000 to Gulab. Amount payable at Indian Overseas Bank, Darya Ganj, Delhi.
- July 7 Drew a bill of exchange for Rs. 2,500 at 3 months on Moti Ram, who immediately accepted it.
- July 12 Received Hoshiar Singh's acceptance dated 15th June, 2007 at 2 months from Hari Darshan Singh. The acceptance was for Rs. 1,500.
- July 16 Accepted a draft of Rs. 5,000 drawn by T.P.S Ray for 4 months. Amount payable at Indian Overseas Bank, Darya Ganj, Delhi.
- July 30 Received Batliboi's acceptance at 3 months for Rs. 3,000.

Solution:

Bills Receivable Book

S. No.	Date	From whom received	Acceptor	Date of Bill	Term	Maturity Date	Amt.	L.F.	How disposed off	Remarks
	2007			2007			Rs.			
1.	July 7	Motiram	Motiram	July 7	3 months	10.10.2007	2,500			
2.	July 12	Hari Darshan Singh	Hoshiar Singh	June 15	2 months	18.8.2007	1,500			
3.	July 30	Batliboi	Batliboi	July 30	3 months	2.11.2007	<u>3,000</u>			
							<u>7,000</u>			

Bills Payable Book

S. No.	Date	Drawn by	Payee	Term	Maturity date	Amt.	L.F.	Payable at	How met	Remarks
	2007					Rs.				
1.	July 2	-	Gulab	3 months	5.10.2007	1,000		IOB Darya Ganj, Delhi.		
2.	July 16	T.P.S. Ray	T.P.S. Ray	4 months	19.11.2007	<u>5,000</u>				
						<u>6,000</u>				

9. POSTING OF BILLS BOOKS

To post Bills Receivable Book, the accounts of acceptors of bills are individually credited with the respective amounts of bills accepted by each one of them and Bills Receivable Account is debited with monthly totals of Bills Receivable Book. As regards Bills Payable Book, the individual accounts of drawers are debited with the amounts of their respective bills and Bills Payable Account is credited with monthly totals of Bills Payable Book.

Other transactions relating to bills, like, discounting, endorsement, dishonor etc., of bills are recorded in Journal even when Bills Receivable Book and Bills Payable Book are maintained.

10. ENDORSEMENT OF BILLS

The payee of a bill of exchange may not himself keep the bill with him. He may transfer the ownership of the bill in favour of another person. Such a person can get the payment of the bill from the drawee. The process of transferring of ownership of the bill is termed as “endorsement” of the bill. The person endorsing the bill is called the “endorser”. The person to whom the bill is endorsed, is called the “endorsee”.

11. DISCOUNTING OF BILL

If the holder of a bill wants to get the money of the bill before its due date, he can do so by selling the bill to a bank or a discounting house against a small charge (discounting charge), it is known as discounting of bill. Discounting charge is imposed by the bank at a certain rate per cent per annum on the amount of the bill for its unexpired period i.e.; the period from the date of discounting to the date of maturity. It may be noted that whenever the bill is discounted, there is a contingent liability which remains till the bill is paid by the acceptor. If it is dishonored due to non-payment, the party who gets it discounted will have to make the payment to the bank.

12. BILLS FOR COLLECTION

The holder of the bill presents the bill on the due date to the drawee for receiving the payment. In a business house many bills are received over a period of time and the date of maturity is different in each case. It is quite difficult for the drawer to remember the dates to present the bills exactly on the date for payment. Therefore the bills may be sent to his bank for collection as and when they are received. Generally banks may charge certain commission for this service. In this case, the bank will present the bills on the due date for payment. In this situation, the bank is only acting as the agent of the holder of the bills. When the bills are collected by the bank on the due date, the banker receives the cash and becomes the debtors to the holder.

13. DAYS OF GRACE

Mostly the amount of bill is payable after the expiry of the specified period of time calculated from the date of the bill. While calculating the due date of such bills, three days of grace have to be added to the term of the bill. In calculating the due date, the date on which the bill is drawn or presented, must be excluded. If the amount of a bill dated 3rd January, 2007, is payable two months after date, the due date of the bill will be 6th March, 2007. Further, if the due date happens to be a public holiday (including Sundays) the bill shall be deemed to be payable the next preceding business day. For example, a bill drawn on 12th May, payable 3 months after date would normally be payable on 15th August being a public holiday, the amount of the bill will be payable on 14th August.

14. ACCOUNTING ENTRIES

After recording the acceptance of the bill, the acceptor usually is not required to pass any entry till due date of the bill arrives. On meeting the bill on due date, the acceptor records payment in Cash Book on credit side saying “By Bills Payable Rs.”. But the firm having a bill receivable may deal with it in one of the four alternative ways, namely:

- (a) It may hold the bill till maturity,
- (b) it may get the bill discounted with bank,
- (c) it may endorse the bill in favour of its creditors,
- (d) it may send the bill to bank with an instruction that on due date, the amount of the bill will be collected by the bank on its behalf and credited to its account with the bank.

The necessary entry in each of the above mentioned cases can be shown in the form of the following table:

	<i>Transaction</i>	<i>Journal Entry</i>
Case (a)	i.e., if the bill is retained till maturity	No entry
Case (b)	i.e., if the bill discounted with bank	Cash A/c / Bank (with amount received) Discount A/c* (amount charged by the bank) To Bills Receivable A/c
Case (c)	i.e., if the bill is endorsed in favour of some party	Endorsee (by name with the amount of bill) To Bills Receivable A/c
Case (d)	i.e., if the bill is sent to bank for collection	Bills for Collection A/c (with amount of bill) To Bills Receivable A/c

On the due date of the bill when the acceptor meets the bill, the entry in the books of the drawer will depend on the way the bill has been dealt with by the drawer.

In Case (a)	Cash/Bank To Bills Receivable Account	Dr.
In Case (b)	No Entry	
In Case (c)	No Entry	
In Case (d)	Bank To Bills for Collection A/c	Dr.

* The amount of discount is always calculated on the basis of the rate of interest and the remaining period of the bill.

15. DISHONOUR OF BILLS

Bill discharges a debt. When the drawee fails to pay the amount of his acceptance to the holder on the date of maturity, the bill is said to be dishonored. But if the bill is dishonored, the parties of the bill are again in the position in which they were placed before the acceptance of the bill. Consequently on dishonour of bill, entries have to be passed to nullify the effect already passed in respect of receipt/ acceptance of the bill.

16. NOTING AND PROTESTING CHARGES

Whenever, a bill is dishonored, it is customary for the holder of such bill to have the fact of dishonour noted and certified by an officer called Notary. The charges payable to Notary for this services are called noting and protesting charges or simply noting charges. The holder makes the cash payment for these charges. Ultimately the acceptor of the bill has to bear the burden of these charges, the endorsee of the bill being entitled to recover them from endorser and the drawer being entitled to be reimbursed for them by the acceptor.

When the bill is dishonored, the acceptor passes the following entry:

Bills Payable Account	Dr.	(amount of bill)
Noting Charges	Dr.	(amount of noting charges)
To Drawer		(total amount)

The entry in the books of the drawer will depend on the way the bill has been dealt with earlier:

Case (a) When the bill is still with drawer:

Drawee/Acceptor (by name)	Dr.	(total amount becoming due on dishonour)
To Bills Receivable A/c		(amount of bill)
To Cash A/c / Bank		(noting charges paid)

Case (b) When the bill has been discounted with the Bank:

Drawee/Acceptor (by name)	Dr.	(amount of the bill + noting charges paid by bank)
To Bank		

Case (c) When the bill has been endorsed:

Drawee/Acceptor (by name)	Dr.	(amount of bill + noting charges paid by endorsee)
To Endorsee (by name)		

Case (d) When the bill has been sent to bank for collection:

Drawee/Acceptor (by name)	Dr.	(amount of bill + noting charges)
To Bills for Collection A/c		(amount of bill)
To Bank		(noting charges)

17. RENEWAL OF BILLS

Sometimes, on due date, the acceptor of a bill requests the drawer to give him extension of time for paying the amount of the bill. If the drawer accedes to his request, the old bill is cancelled and a new one is drawn and accepted. The entries for cancellation of the old bill are the same as for dishonour of the bill. Usually, the acceptor is called upon to pay for interest also for the period for which extension has been granted. Before passing the entries for the new bill, the entries for the interest will also have to be passed. The entries for interest are:

In the books of drawer:

Acceptor (by name)	Dr.
To Interest Account	

In the books of acceptor

Interest Account	Dr.
To Drawer (by name)	

The amount of interest may be paid in cash by acceptor or may be included in the amount of the new bill. If the acceptor pays part for the old bill in cash, the new bill will be drawn and accepted only for the balance plus interest thereon for the period of the new bill.

Illustration 2 :

Puri owed Suri Rs. 10,000. On 2nd January, 2007 Puri accepted four bills exchange drawn by Suri to discharge the debt. The first for Rs. 1,000 at one month, the second for Rs. 2,000 at two months, the third for Rs. 3,000 at three months and the last one for Rs. 4,000 at four months. On 15th January Suri sent the first bill to the bank for collection. On 17th January he endorsed the second bill in favour of Murti. On 5th February, he got the fourth bill discounted with the bank @16% p.a. The first three bills were duly honored but the fourth one (i.e. the discounted one) was dishonored on the due date, noting charges being Rs. 25.

Show journal entries and important ledger accounts in the books of Puri as well as Suri.

Solution :

Suri's Journal

	Dr.	Cr.
2007	Rs.	Rs.

Jan. 2	Bills Receivable Account To Puri (Receipt of four acceptances from Puri)	Dr.	10,000	10,000
Jan. 15	Bills for Collection A/c To Bills Receivable Account (Amount of the first bill sent to bank for collection)	Dr.	1,000	1,000
Jan. 17	Murti To Bills Receivable Account (Endorsement of the bill for Rs. 2,000 in favour of Murti)	Dr.	2,000	2,000
2007			Rs.	Rs.
Feb. 5	Bank Account Discount Account To Bills Receivable Account (Proceeds of the bill for Rs. 4,000 on discounting)	Dr.	3840 160	4,000
Feb. 5	Bank Account To Bills for Collection A/c (Debit to bank for amount collected by it from Puri for his acceptance)	Dr.	1,000	1,000
April 5	Bank Account To Bills Receivable Account (Amount received on maturity of the acceptance for Rs. 3,000)	Dr.	3,000	3,000
May. 5	Puri To Bank Account (Debit to Puri and credit to bank on dishonor of Puri's acceptance for Rs. 4,000 which was got discounted with the Bank on Feb. 5, 2007. The debit and the credit include the amount of noting charges Rs. 25)	Dr.	4,025	4,025

**Ledger Accounts
Puri**

Dr.					Cr.
2007		Rs.	2007		Rs.
Jan. 1	To Balance b/d	10,000	Jan. 2	By Bills Receivable A/c	10,000
May. 5	To Bank A/c	<u>4,025</u>		By Balance c/d	<u>4,025</u>
		<u>14,025</u>			<u>14,025</u>
	To Balance c/d	4,025			

Bills Receivable Account

2007		Rs.	2007		Rs.
Jan. 2	To Puri	10,000	Jan. 15	By Bills for Collection A/c	1,000

	Jan. 17	By Murti	2,000
	Feb. 5	By Bank	3,840
	Feb. 5	By Discount A/c	160
	April 5	By Bank A/c	<u>3,000</u>
			<u>10,000</u>

Puri's Journal

			<i>Dr.</i>	<i>Cr.</i>
2007			<i>Rs.</i>	<i>Rs.</i>
Jan. 2	Suri	Dr.	10,000	
	To Bills Payable Account			10,000
	(Acceptance given to Suri)			
Feb. 5	Bills Payable Account	Dr.	1,000	
	To Bank Account			1,000
	(Payment for the first acceptance)			
Mar. 5	Bills Payable Account	Dr.	2,000	
	To Bank Account			2,000
	(Payment for the second acceptance)			
April 5	Bills Payable Account	Dr.	3,000	
	To Bank Account			3,000
	(Payment of the third acceptance)			
May 5	Bills Payable Account	Dr.	4,000	
	Noting Charges Account	Dr.	25	
	To Suri			4,025
	(Dishonor of the fourth acceptance, noting charges being Rs. 25)			

Ledger Accounts Suri

<i>Dr.</i>			<i>Cr.</i>
2007		2007	<i>Rs.</i>
Jan. 2	To Bills Payable A/c	Jan. 1	By Balance b/d
	To Balance c/d	May 5	By Bills Payable A/c
		May 5	By Noting Charges A/c
			<u>25</u>
			14,025
			<u>14,025</u>
			By Balance b/d
			4,025

Bills Payable Account

2007		<i>Rs.</i>	2007		<i>Rs.</i>
Feb. 5	To Bank A/c	1,000	Jan. 2	By Suri	10,000
Mar. 5	To Bank A/c	2,000			
April 5	To Bank A/c	3,000			
May 5	To Suri	<u>4,000</u>			
		10,000			<u>10,000</u>

18. INSOLVENCY OF DRAWEE

Insolvency or bankruptcy means the inability of a person to pay the amount owned by him. This means that bill accepted by him will be dishonoured. Therefore, when it is known that a person has become insolvent, entry for dishonor of his acceptance should be passed. It is common that some amount may be realised from the property of the insolvent acceptor. It is called dividend and is generally expressed as so many paise in the rupee in full satisfaction of the claim of the drawer or creditor. When and if an amount is received, cash account will be debited and personal account of the debtor will be credited. The unsatisfied amount or the balance still owing represents the irrecoverable debt and has to be debited to Bad Debts Account in the books of the drawer or creditor and credited to Deficiency Account in the books of the acceptor or debtor. The journal entries are as follows:

Drawer's Book :

(i) Acceptor	Dr.	
To Bills Receivable Account		(if bill retained)
To Bank Account		(if discounted with bank)
To Endorsee		(if endorsed)
(For bill dishonored on insolvency)		
(ii) Cash Account/Bank Account	Dr.	(with the actual amount received)
Bad Debts Account	Dr.	(with the irrecoverable amount)
To Acceptor		(with the total)
(Receipt of final dividend and balance written off as bad debts)		

Acceptor's Books :

Bills Payable Account	Dr.	
To Drawer		
(Dishonor of the bill on insolvency)		
Drawer Dr.		(with the total amount due)
To Bank Account		(with the amount paid)
To Deficiency Account		(with the amount not paid)
(Final dividend paid to creditors)		

Illustration 3 :

X purchased goods from Y for Rs. 2,000 on 1st January, 2007. He accepted a bill of exchange for the amount at 2 months drawn on him by Y the same day. On 4th January, 2007 Y got the bill discounted with his bank at 18 per cent. At maturity the bill was dishonoured, noting charges amounting to Rs. 15. However, Y agreed to receive the sum of Rs. 575 from X in cash and two promissory notes - one at one month for Rs. 500 and the other at 3 months for Rs. 1,000 in full settlement. The first promissory note was duly honoured but the second note was dishonoured due to X's insolvency. Y could recover 30% of the amount due from him.

Show Journal entries in the books of both the parties and X's account in Y's ledger.

Solution

In the Book of Y			
Journal Entries			
		Dr.	Cr.
		Rs.	Rs.
2007			
Jan. 1	X		
		Dr.	
	To Sales Account	2,000	2,000

	(For credit sale to X)			
Jan. 1	Bills Receivable Account	Dr.	2,000	
	To X			2,000
	(For acceptance received form X)			
Jan. 4	Bank	Dr.	1,940	
	Discount Account	Dr.	60	
	To Bills Receivable Account			2,000
	(For proceeds of the bill discounted @18% per annum)			
Mar. 4	X	Dr.	2,015	
	To Bank			2,015
	(For amount of X's dishonoured acceptance and the noting charges paid thereon by bank)			
Mar. 4	X	Dr.	60*	
	To Interest Account			60
	(For interest receivable from X on account of renewal of his acceptance)			
Mar. 4	Cash Account	Dr.	575	
	Bills Receivable Account	Dr.	1,500	
	To X			2,075
	(For cash and promissory notes received from X)			
April 7	Cash Account	Dr.	500	
	To Bills Receivable A/c			500
	(Amount received on maturity of the promissory note at one month for Rs. 500)			
June 7	X	Dr.	1,000	
	To Bills Receivable Account			1,000
	(For dishonour of promissory note on X's insolvency)			
			Dr.	Cr.
2007			Rs.	Rs.
?	Cash Account	Dr.	300	
	Bad Debts Account	Dr.	700	
	To X			1,000
	(Amount received from official receiver, the balance in X's account being written off as bad debt)			

		Ledger Account			
Dr.		X		Cr.	
2007		Rs.		2007	
Jan. 1	To Sales	2,000	Jan. 1	By Bills Receivable A/c	2,000
Mar. 4	To Bank	2,015	May 5	By Bills Receivable A/c	1,500
Mar. 4	To Interest	60	May 5	By Cash A/c	575
June 7	To Bills Receivable A/c	1,000		By Cash A/c	300

* **Note:** The amount of the old bill together with noting charges was Rs. 2,015. X pays in all Rs. 2,075 (Rs. 575 in cash and Rs. 1,500 by way of promissory notes). The difference between Rs. 2,075 and Rs 2,015 i.e. Rs. 60 is for the interest.

<u>5,075</u> -----	By Bad Debts A/c	<u>700</u> <u>5,075</u> -----
-----------------------	--------------------	-------------------------------------

**In the Books of X
Journal Entries**

			<i>Dr.</i>	<i>Cr.</i>
			<i>Rs.</i>	<i>Rs.</i>
2007				
Jan. 1	Purchases Account	Dr.	2,000	
	To Y			2,000
	(For credit purchase of Y)			
Jan. 1	Y	Dr.	2,000	
	To Bills Payable Account			2,000
	(For acceptance given to Y)			
Mar. 4	Bills Payable Account	Dr.	2,000	
	Noting Charges	Dr.	15	
	To Y			2,015
	(For dishonoured acceptance to Y and amount of noting charges thereon)			
Mar. 4	Interest Account	Dr.	60	
	To Y			60
	(For interest payable to Y on renewal of acceptance)			
			<i>Dr.</i>	<i>Cr.</i>
			<i>Rs.</i>	<i>Rs.</i>
2007				
Mar. 4	Y	Dr.	2,075	
	To Cash			575
	To Bills Payable Account			1,500
	(For cash and promissory notes given to Y)			
April 7	Bills Payable Account	Dr.	500	
	To Cash Account			500
	(For payment on maturity of promissory note)			
June 7	Bills Payable Account	Dr.	1,000	
	To Y			1,000
	(Dishonour of acceptance due to insolvency)			
?	Y	Dr.	1,000	
	To Cash Account			300
	To Deficiency Account			700
	(For dividend paid to Y and amount not paid due to insolvency)			

19. RETIRING A BILL UNDER REBATE

At times, in order to earn a rebate, the acceptor of a bill may desire to discharge his liability

before the due date of the bill. If the holder agrees, the acceptor will pay to the holder the amount of the bill as reduced by the amount of rebate agreed upon between the acceptor and the holder of the bill. For the holder, the transaction will be similarly to the one of getting bill discounted as he will have to surrender the bill before the due date on receipt of amount, which is less than its face value. Of course, a discounted bill can be dishonoured; the question of dishonour does not arise in case of a retired bill.

On retirement of a bill under rebate, the entries will be as follows:

In the books of holder:

Cash Account	Dr.	(cash received)
Discount Account	Dr.	(rebate allowed)
To Bills Receivable Account		

In the books of acceptor:

Bills Payable Account	Dr.
To Cash Account	
To Discount Account	

20. ACCOMMODATION BILLS

Generally, a bill is drawn and accepted only when some debt is outstanding and such bill is known as a trade bill. But sometimes a bill is drawn not to settle up an outstanding claim but for the financial accommodation of the drawer as well as the acceptor. If the bill is for the accommodation of the drawer only, the drawer will discount the bill and will utilise the funds. Before maturity, the drawer will furnish the drawee with funds to honour the bill. Alternatively, the proceeds of accommodation bill may be divided by the parties amongst themselves. In such a case, the discount is also to be borne by them in the same proportion in which proceeds have been shared. It is also possible that both the parties may draw bills on each other, accept the bills, get them discounted and share the proceeds. On the due date the parties settle their accounts and pay for their respective acceptances. Suppose X is in need of Rs. 5,000 and he is able to persuade Y to accept a bill for the amount. X will get the bill discounted, use the proceeds for the period of the bill and then remit the amount of the bill to Y who will meet the bill. If both X and Y are in need of funds, they may either share the proceeds of one bill or each party may issue an acceptance to the other which will then be discounted. Suppose both X and Y need Rs. 5,000 each; one of them may accept a bill of Rs. 10,000 and send it to the other who will get it discounted and then remit half the proceeds to the acceptor. On the due date, the acceptor will receive Rs. 5,000 more from the drawer and meet the bill for Rs. 10,000. An alternative course is that X may accept Y's draft for Rs. 5,000 and Y may accept X's draft for Rs. 5,000. Each party will get the bill discounted meeting own acceptance at the due date. The parties to an accommodation bill may share the proceeds unequally. A settlement will be made between them on the due date. It must be remembered that each party has to bear the discount in proportion of funds utilised by it.

21. DISTINCTION BETWEEN TRADE BILL AND ACCOMMODATION BILL

- (i) A trade bill arises from an indebtedness arising from purchase of goods or taking of a loan whereas an accommodation bill is drawn and accepted only for providing fund to one of the parties or both the parties of the bill.
- (ii) On discount of a trade bill, full amount is retained by the drawer. In an accommodation bill however the amount may be shared by the drawer and the drawee in an agreed ratio.
- (iii) Consideration is present in the trade bill while in accommodation bill there is no consideration.
- (iv) Trade bill acts as an evidence of indebtedness while accommodation bill acts as a source of finance.

- (v) In order to recover the debt, the drawer can initiate legal action on a trade bill. In accommodation bill, legal remedy for the recovery of amount is not available for immediate parties.

Illustration 4 :

For their mutual accommodation, P drew and Q accepted on 1st January, 2007 a bill of exchange for Rs. 2,000 at 2 months. On 4th January, 2007 P got the bill discounted with the bank receiving Rs. 1,940 for it and remitted half the proceeds to Q. On due date of the bill, P expressed his inability to send the amount due but agreed to accept a bill of exchange for Rs. 2,500 at 3 months drawn on him by Q. Q got the bill discounted for Rs. 2,400 and remitted Rs. 200 to P. Before the due date of this bill, P became insolvent. Later 40% dividend was received from his estate.

Pass the journal entries in the books of P and Q to record the above mentioned transactions. Also show ledger accounts in Q's Ledger.

Solution:

In the Books of P			Dr.	Cr.
Journal Entries				
			Rs.	Rs.
2007				
Jan. 1	Bills Receivable Account Dr. To Q (For acceptance received form Q)		2,000	2,000
Jan. 4	Bank Dr. Discount Account Dr. To Bills Receivable Account (Proceeds of the bill on its discounting)		1,940 60	2,000
Jan. 4	Q Dr. To Bank To Discount Account (Half the proceeds remitted to Q)		1,000	970 30
Mar. 4	Q Dr. To Bills Payable Account (Acceptance given to Q)		2,500	2,500
Mar. 4	Bank Dr. Discount Dr. To Q (For cash received from Q after adjusting discount amounting to Rs. 50)		200 50	250
Mar. 4	Bills Payable Account Dr. To Q (Dishonour of acceptance to Q on own insolvency)		2,500	2,500
Mar. 4	Q Dr. To Bank To Deficiency Account (Amount paid to Q as 40% dividend, the balance being transferred to Deficiency Account)		1,250	500 750
In the Books of Q				

Journal Entries

			<i>Dr.</i>	<i>Cr.</i>
			<i>Rs.</i>	<i>Rs.</i>
2007				
Jan. 1	P	<i>Dr.</i>	2,000	
	To Bills Payable Account			2,000
	(Acceptance given to P for mutual accommodation)			
Jan. 4	Bank	<i>Dr.</i>	970	
	Discount	<i>Dr.</i>	30	
	To P			1,000
	(Half the proceeds of the bill received from P)			
Mar. 4	Bills Payable Account	<i>Dr.</i>	2,000	
	To Bank			2,000
	(Payment for acceptance on due date)			
Mar. 4	Bills Receivable Account	<i>Dr.</i>	2,500	
	To P			2,500
	(Acceptance received from P)			
Mar. 4	Bank	<i>Dr.</i>	2,400	
	Discount	<i>Dr.</i>	100	
	To Bills Receivable Account			2,500
	(For proceeds received on getting P's acceptance discounted)			
Mar. 4	P	<i>Dr.</i>	250	
	To Bank Account			200
	To Discount Account			50
	(Amount remitted to P and discount charged)			
	P	<i>Dr.</i>	2,500	
	To Bank			2,500
	(Dishonour of P's acceptance on his insolvency)			
	Bank	<i>Dr.</i>	500	
	Bad Debts Account	<i>Dr.</i>	750	
	To P			1,250
	(40% dividend received from P, the balance being written of as bad debt)			

In the Books Q Ledger Accounts

Dr.				Cr.			
2007		Rs.	2007			Rs.	
Jan. 1	To Bills Payable A/c	2,000	Jan. 4	By Bank		970	
Mar. 4	To Bank	200	Jan. 4	By Discount A/c		30	
Mar. 4	To Discount A/c	50	Mar. 4	By Bills Receivable A/c		2,500	
	To Bank	2,500		By Bank		500	
				By Bad Debts A/c		750	
		<u>4,750</u>				<u>4,750</u>	

Bills Payable Account			
Dr.			Cr.
2007		Rs. 2007	Rs.
Mar. 4	To Bank	2,000	Jan. 1 By P 2,000
		-----	-----

Bills Receivable Account			
2007		Rs. 2007	Rs.
Jan. 4	To P	2,500	Mar. 4 By Bank 2,400
		-----	-----
		2,500	Mar. 4 By Discount A/c 100
		-----	-----
			2,500

Note : The Discount to be borne by P is arrived at as follows:

Rs. 1,000 due by him but not remitted to Q
 + 200 received by him from Q
Total Rs. 1,200

Rs. 1,200 is 1/2 of Rs. 2,400 (amount received by Q on discount of the bill). Hence, P should bear 1/2 of the discount.

Illustration 5

X draws a bill for Rs. 30,000 and Y accepts the same for the mutual accommodation of both of them to the extent of X two-thirds and Y one-third. X discounts the same for Rs. 28,200 and remits one-third of the proceeds to Y. Before the due date, Y draws another bill for Rs. 42,000 on X in order to provide funds to meet the first bill. The second bill is discounted for Rs. 40,800 with the help of which first bill is met and Rs. 7,200 are remitted to X. Before the due date of the second bill, X becomes bankrupt and Y receives a dividend of 50 paise in a rupee in full settlement. Prepare Y's account in X's ledger.

Solution:

In X' Ledger Y's Account			
Dr.			Cr.
Particulars	Rs.	Particulars	Rs
To Bank	9,400	By Bills Receivable A/c	30,000
To Discount A/c	600	By Bank	7,200
To Bills Payable A/c	42,000	By Discount A/c	800
To Bank	14,000	By Bills Payable A/c	42,000
To Deficiency	<u>14,000</u>		
	<u>80,000</u>		<u>80,000</u>

Share of Discount :

After discounting of the 1st bill X received 20,000
Add : Amount remitted by Y 7,200
27,200

But the benefit enjoyed by Y Rs. (40,800 – 27,200) = 13,600

Ratio in which discount charges are to be borne by them – 2720 : 1360 or 2 : 1

Hence X will share Rs.1, 200 x 2/3 = Rs.800

SELF-TEST QUESTIONS

1. Enumerate the points of distinction between a bill of exchange and a promissory note.
2. What is the importance of bills of exchange and promissory notes in modern trade?
3. What do you mean by accommodation bills? Why are they drawn and what is their importance?
4. Distinguish between a trade bill and an accommodation bill.
5. Explain the term “days of grace”. How is due date of a bill affected by days of grace? Give examples.
6. What are noting charges? Why are they paid? Who pays them? On whom does the burden of noting charges fall ultimately?
7. Who is notary public? What is his function in relation to bills?
8. Distinguish between a bills receivable and a bills payable.
9. What do you understand by the term endorsement? What is the effect of endorsement of a bill of exchange?
10. What is the procedure of renewal of a bill?
11. What is the effect of retirement of a bill?
12. What do you mean by dishonour of a bill?
13. Which of the following statements are false:
 - (a) If the due date of a bill falls on Sunday, the amount can be paid on the following day i.e. on Monday.
 - (b) One can tell by regarding the subject matter of a bill of exchange whether the bill is a trade bill or accommodation bill.
 - (c) On dishonour of a bill, the holder has to bear the noting charges payable to notary.
 - (d) Transactions relating to bills of exchange are recorded in bills receivable book whereas the transactions relating to promissory notes are recorded in bills payable book.
 - (e) Drawee of a bill of exchange becomes liable on the bill only after he has accepted it.

(Ans.: First four statements are false)
14. Journalise the following transaction in the books of Gupta:
 - (a) Gupta's acceptance to Sharma for Rs. 2,500 discharged by a cash payment of Rs. 1,500 and a new acceptance for the balance plus Rs. 25 for interest.
 - (b) Gupta retires an acceptance for Rs. 1,000 for a rebate of Rs. 10.
 - (c) Gupta discharges an acceptance to Verma for Rs. 500 by means of an acceptance of like sum received from Mittal.
 - (d) Gupta receives Rs. 3,040 in cash and a promissory note for Rs. 2,000 from Khurana in discharge of his acceptance for Rs. 5,000.
15. On 1st August 2007, A accepts a two months bill for Rs. 2,200 drawn by B for the mutual accommodation of both. The latter then discounts the bill with his bankers for Rs. 2,134 and the proceeds are shared equally between the parties, but B fails to pay A his share of the amount, and instead accepts a two months bill for the amount due by him including

interest at 12% per annum. The bill is then met by B on the due date. Show by journal entries and the ledger accounts to record of these transactions in the books of both the parties concerned.

16. For the mutual accommodation of both the parties, on 1st January, 2007 Chakraborty draws on Santhanam a four months bill for Rs. 3,000 and discounts the same with his bankers at 12% per annum. On the same date and for similar purpose, Santhanam draws a four months bill for Rs. 4,000 on Chakraborty and after securing acceptance, discounts the same with his bankers at the rate of 12% per annum. Chakraborty meets his acceptance on the due date, but Santhanam becomes bankrupt on maturity and a dividend of 20 paise in the rupee is paid from his asset on his debts. Show by journal entries and ledger accounts how the transactions would be recorded in the books of both these parties.
17. On 1st January, 2007 Prakash receives 2 acceptances from Mahesh, one for Rs. 2,000 payable in two months, and other for Rs. 4,000 payable in 4 months in full settlement of account. Both these bills are duly discounted by Prakash with his bankers on 3rd January at 12%.

Before maturity of the first bill, Mahesh requests Prakash to assist him in taking it up advancing Rs. 1,000 in cash and drawing a 3rd bill on him for a like amount at 3 months date from due date of the first bill, plus interest at 12% per annum. Prakash does the needful and discounts the new bill at 12 per cent.

Just before the maturity of the second bill for Rs. 4,000 Mahesh again requests Prakash to assist him to the extent of Rs. 2,500. In order to help Mahesh, Prakash arranges with Mahesh to draw on him (Prakash) two bills for Rs. 1,000 and Rs. 1,500 at 2 months and 3 months respectively from the due date of the second bill. Prakash duly accepts these two bills and delivers them to Mahesh who discounts at 12 per cent. He then duly meets the bill for Rs. 4,000. Prakash also meets his two acceptances on maturity. On 30th May Mahesh becomes bankrupt leaving his 3rd bill unpaid and nothing was recovered from his estate in respect of the claim.

Make the necessary journal entries and ledger accounts in the books of both the parties to record the above transactions.

18. Denaji draws on Lenaji a bill of exchange of Rs. 1,500 on 1st April, 2007 for 3 months. Lenaji accepts the bill and sends it to Denaji, who gets it discounted for Rs. 1,440. Denaji immediately remits Rs. 480 to Lenaji. On the due date Denaji, being unable to remit the amount due accepts a bill for Rs. 2,100 for 3 months which is discounted by Lenaji for Rs. 2,010. Lenaji sends Rs. 340 to Denaji.

Before maturity of the bill Denaji becomes bankrupt, his estate paying 50 paise in the rupee.

Give journal entries in the books of both Denaji and Lenaji. Also show Denaji's account in Lenaji's books and Lenaji's account in Denaji's books.

19. A draws on B a bill of exchange for 3 months for Rs. 4,000 and agrees that the proceeds of the bill should be shared equally. He discounts the acceptance receiving Rs. 3,820 in cash of which he sends B Rs. 1,910. On the due date, A being unable to remit the amount due, accepts a bill of Rs. 6,000 for 3 months which is discounted by B for Rs. 5,730 of which he sends Rs. 865 to A. Before the maturity of the bill A becomes insolvent, his estate paying thirty five paise in the rupee. Give journal entries in the books of both the parties. Also show A's account in B's books.

Suggested Readings :

- (1) *M.C. Shukla, T.S. Grewal and S.C. Gupta* — Advanced Accounts, Vol. I
(2) *J.R. Monga* — Advanced Financial Accounting

- (3) *S.N. Maheshwari* — Financial Accounting
 - (4) *Ashok Sehgal & Deepak Sehgal* — Financial Accounting
-

STUDY VIII

ACCOUNTS OF NON-PROFIT ORGANISATIONS

1. INTRODUCTION

There are institutions like schools, colleges, hospitals, clubs, associations which are established not to run a business and earn profits but for social service, charitable or similar other purposes. Such institutions are called non-trading or non-profit organisations. Donations, subscriptions, entrance fees and income from charity show, etc., are the sources of income of these organisations. Expenditure is incurred for fulfilling the objects for which the particular concern has been established. Although such concerns do not keep profit earning as their object, yet they have to maintain accounting records to avoid public criticism. They prepare income statement and balance sheet to ascertain whether during a particular year, income has been more than expenditure or expenditure has exceeded income and the financial position of the concern at the end of the year. It is because such concerns have also to exist within their means and keep their financial position sound so that they may continue to work for their objectives in future also. If even a charitable institution starts spending more than what it receives by way of income, it will have to be closed down sooner or later.

The following are the features of non-profit organizations:

- (i) The main aim of non-profit organizations is to render services to various sections of the society for which people of the society will be charged either free of cost or charge at no profit and no loss basis.
- (ii) Non-profit organization raise funds from agencies who neither accept return for their donations nor desire benefits for the resources they provide.
- (iii) Such organizations earn their reputation on the basis of their contribution to the society.
- (iv) There is no individual or joint ownership as regards non-profit organisations. The identity on behalf of the society is considered as the honour and its ownership can neither be transferred nor be sold.
- (v) Management of the organization is entrusted to persons having interest in rendering services and who have no recoverable investment with them.

2. RECEIPTS AND PAYMENTS ACCOUNT

In a non-trading concern, most of the transactions are cash transactions. Such an entity therefore, may keep only a cash book and the few credit transactions that may take place may be recorded in a memorandum books. However, even when the institution is a big one and maintains elaborate books of account to record all the transactions on double entry system, the Cash Book continues to be very important. Hence along with final accounts, a statement called Receipts and Payments Account is also prepared which is really a summary of the Cash Book. Like Cash Book, it starts with opening balance of cash in hand and cash at bank, all receipts are shown on debit side, all payments are shown on credit side and the statement ends with closing balance of cash in hand and at bank. In fact if the yearly transactions are purely in cash and there are no properties and liabilities, Receipts and Payments Account is the only final account of the year.

The following are the main features of receipts and payments account :

- (i) It is a real account i.e. it is a summarized copy of receipts and payments of cash.
- (ii) In the form of receipts and payments account is similar to cash book, where receipts are recorded under debit side and payments are under credit side.
- (iii) It records all receipts and payments irrespective of the distinction between capital and revenue items i.e. both capital and revenue receipts and payments are included in this account.
- (iv) Only the actual receipts and payments during the accounting period are recorded in this account.
- (v) The opening balance in this account means cash in hand/bank in the beginning of the accounting period while closing balance relates to cash in hand/bank at the end of the accounting period.

3. INCOME AND EXPENDITURE ACCOUNT

Income and Expenditure Account is prepared in non-trading concerns to ascertain whether in a particular year expenditure has exceeded income or income has exceeded expenditure along with the amount of such excess. It is prepared by transfer of nominal accounts. Actually all those principles which are applicable for preparation of Trading and Profit and Loss Account in a trading concern are applicable to the preparation of Income and Expenditure Account. For example, a clear distinction must be made between capital and revenue items; the matching principle is also followed. One can say that in non-trading concerns, Income and Expenditure Account takes the place of Profit and Loss Account. As earning of profit is not the objective of non-trading concerns, it is legitimate to name their Profit and Loss Account as Income and Expenditure Account. For the same reason, in such concerns, net profit is called 'surplus, i.e., excess of income over expenditure' and net loss is called 'deficit, i.e., excess of expenditure over income'. As in Profit and Loss Account, in Income and Expenditure Account also, expenses are shown on debit side, incomes are shown on credit side and only revenue items for the year after necessary adjustments appear. Surplus or deficit revealed by income and expenditure account is transferred to an account called 'Capital Fund' which takes the place of Capital Account in non-trading concerns. Income and expenditure account is accompanied by balance sheet as at the end of the year.

4. DISTINCTION BETWEEN RECEIPTS AND PAYMENTS ACCOUNT AND INCOME AND EXPENDITURE ACCOUNT

Both Receipts and Payments Account and Income and Expenditure Account are prepared by non-profit concerns. The basic difference between the two is that whereas Receipts and Payments Account is a summary of Cash Book, Income and Expenditure Account takes the place of Profit and Loss Account. The various points of distinction flowing from this basic difference can be described as follows:

	<i>Receipts and Payments Account</i>	<i>Income and Expenditure Account</i>
(1)	Being a summary of Cash Book, it is not an essential part of record. It is in the nature of a statement prepared on the basis of record in Cash Book.	The account is an essential part of record of transactions based on double entry system in a non-trading concern, as it takes the place of Profit and Loss Account.
(2)	Receipts are shown on debit side and payments are shown on credit side.	Incomes are shown on credit side and expenses are shown on debit side.
(3)	It starts with the opening balance of cash in hand and at bank.	It has no opening balance.

(4)	The difference of two sides is the cash in hand and at bank at the end of the period.	The difference is either surplus or deficit for the period; if credit side is heavier, it is surplus whereas if debit side is heavier, it is deficit.
(5)	Only cash transactions find place.	Other transactions also find place.
(6)	Capital as well as revenue items appear.	Only revenue items appear.
(7)	All receipts and payments are shown irrespective of the year to which they pertain.	Only those expenses and incomes are shown which relate to the period for which the account is prepared.
(8)	It is not necessary to prepare balance sheet alongwith this statement.	It is always accompanied by balance sheet.

5. PROFIT AND LOSS ACCOUNT AND INCOME AND EXPENDITURE ACCOUNT

The distinction between profit and loss account and income and expenditure account may be stated as follows:

<i>Profit and Loss Account</i>	<i>Income and Expenditure Account</i>
(i) This is prepared by business run for earning profit.	This is prepared by non-trading/ charitable organisations.
(ii) The credit balance of this account is known as "net profit" and added to capital.	Credit balance of this account is known as 'excess of income over expenditure' or surplus and added to capital fund.
(iii) Debit balance of this account is known as 'net loss' and deducted from the capital.	Debit balance of this account is known as 'excess of expenditure over income' or deficit and deducted from the capital fund.

6. BALANCE SHEET

The balance sheet of non-trading concerns is prepared on the same lines as that of a trading concerns showing assets on the right hand side and liabilities on the left hand side. The balance sheet contains all assets and liabilities including capital fund as on a particular date. Items like outstanding expenses and income, prepaid expenses and income received in advance, etc. are incorporated in the balance sheet. The surplus or deficit so ascertained from income and expenditure account is added to or deducted from the capital fund. If the capital fund is not given, the same is to be computed by preparing the opening balance sheet of the concerns which is nothing but excess of assets over liabilities.

7. PREPARATION OF INCOME AND EXPENDITURE ACCOUNT ON THE BASIS OF RECEIPTS AND PAYMENTS ACCOUNT

In order to prepare Income and Expenditure Account on the basis of Receipts and Payments Account, examine one by one all the items appearing in Receipts and Payments Account, exclude opening and closing balances of cash in hand and at bank. Also exclude all capital receipts and all capital payments. Now after necessary adjustments which we shall discuss presently, the revenue receipts appearing on debit (receipts) side of Receipts and Payments Account are recorded on credit (income) side of Income and Expenditure Account and the expenses appearing on credit (payments) side of Receipts and Payments Account, are recorded

on debit (expenditure) side of Income and Expenditure Account. Adjustments have to be made because in Income and Expenditure Account, all income pertaining to the year for which the account is being prepared has to be shown even if it has not been received in cash or even it was received in a previous year and all income received for previous year or subsequent year has to be excluded. Similarly, all expenses pertaining to the year for which Income and Expenditure Account is prepared are included whether paid or not or already paid in a previous year; and all expenses paid in the year for which Income and Expenditure Account is prepared but which relate to a previous or subsequent year have to be excluded. There are some items like depreciation on fixed assets and loss on sale of a fixed asset which will have to be shown in Income and Expenditure Account although they do not appear in Receipts and Payments Account. Surplus or deficit revealed by Income and Expenditure Account is transferred to Capital Fund.

Illustration 1:

The NSS Club provides the following Receipts and Payments account for the year ended 31st December, 2007. You are required to prepare an Income and Expenditure Account and the Balance Sheet as on 31.12.2007.

<i>Receipts</i>		<i>Rs.</i>	<i>Payments</i>		<i>Rs.</i>
To Opening Bank Balance		2,50,000	By Telephone Expenses		8,500
To Subscriptions :			By Postage Expenses		8,000
<i>Receipts</i>		<i>Rs.</i>	<i>Payments</i>		<i>Rs.</i>
2006	10,000		By Purchase of Books		35,000
2007	90,000		By Salaries		20,000
2008	<u>6,000</u>	1,06,000	By Entertainment Expenses		15,000
To Donations		20,000	By Purchase of National		
To Sale Proceeds of			Saving Certificates		80,000
Waste Material		4,750	By Miscellaneous Expenses		6,750
To Hall Rent		15,000	By Closing Balance:		
To Bank Interest		2,500	Cash		15,000
To Admission Fee of			Bank		2,30,000
new members					
(10% to be capitalised)		<u>20,000</u>			
		<u>4,18,250</u>			<u>4,18,250</u>

The following additional information is also given by the Club regarding outstanding expenses and income as on 31st December, 2007:

- | | |
|--|------------|
| (i) Salaries outstanding | Rs. 15,000 |
| (ii) Miscellaneous expenses outstanding | Rs. 4,000 |
| (iii) Entertainment expenses outstanding | Rs. 8,000 |
| (iv) Bank interest receivable | Rs. 4,500 |

Solution:

N S S Club
Income and Expenditure Account
for the year ended 31st December, 2007

<i>Expenditure</i>	<i>Rs.</i>	<i>Income</i>	<i>Rs.</i>
To Telephone expenses	8,500	By Subscriptions	90,000
To Postage expenses	8,000	By Donations	20,000
To Salaries	20,000	By Hall rent	15,000
Add: Outstanding salaries	15,000	By Bank interest	2,500
	35,000	Add: Receivable	4,500
To Entertainment expenses	15,000	By Sale Proceeds of waste material	4,750
Add: Outstanding	8,000	By Admission fee (90% of total)	18,000
To Miscellaneous expenses	6,750		
Add: Outstanding	4,000		
To Excess of Income over Expenditure transferred to Capital Fund	69,500		
	<u>1,54,750</u>		<u>1,54,750</u>

**N S S Club Balance Sheet
as at 31st December, 2007**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
	<i>Rs.</i>		<i>Rs.</i>
Capital Fund	2,60,000	Books	35,000
Add: 10% of Admission fee	2,000	Investments in National Saving Certificates	80,000
Excess of Income over Expenditure	69,500	Bank Interest Receivable	4,500
Outstanding	3,31,500	Cash at bank	2,30,000
Expenses:		Cash in hand	15,000
Salaries	15,000		
Miscellaneous expenses	4,000		
Entertainment expenses	8,000		
Subscription received in advance for 2008	6,000		
	<u>3,64,500</u>		<u>3,64,500</u>

Note : Calculation of Capital Fund as on 1.1.2007

Opening Bank Balance	2,50,000
Add : Subscription for 2006	10,000
	<u>2,60,000</u>

8. PREPARATION OF INCOME AND EXPENDITURE ACCOUNT AND BALANCE SHEET WHEN TRIAL BALANCE IS GIVEN

When trial balance is given, preparation of Income and Expenditure Account is on the same line as the preparation of a Profit and Loss Account on the basis of accuracy of Cash Book. The

following points may be kept in mind while preparing Income and Expenditure Account from the given trial balance:

1. All incomes should be shown on the right hand side and the expenses on the left hand side of the account.
2. Only income and expenditure of the related period should be entered into account. The income accrued or the expenditure outstanding should be adjusted in the account.
3. The excess of left side of the account will show excess of expenditure over income whereas the excess of right side will show excess of income over expenditure.
4. The surplus is not distributed as profits rather it is added in the accumulated capital fund. Similarly deficit will be deducted from the accumulated fund.

Illustration 2 :

Prepare Income and Expenditure Account and Balance Sheet as on 31.3.2007 from the following Trial Balance:

P.P. Sports Club
Trial Balance as on 31st March, 2007

<i>Debit Balance</i>	<i>Rs.</i>	<i>Credit Balance</i>	<i>Rs.</i>
Cash in Hand	6,000	Members Subscription received	36,000
Cash at Bank	15,000	Miscellaneous Receipts	3,000
Table Tennis Table	10,000	Annual Programme-sale	
Billiards Table	8,000	of tickets	4,000
Glass and Cutlery	4,000	Creditors	2,000
Salary and Wages	12,000	Donations	20,000
Repairs	2,400	Capital Fund	10,400
Light	1,000		
Entertainment	8,000		
Annual Programme	3,000		
Debtors	5,000		
Sundry Expenses	1,000		
	<u>75,400</u>		<u>75,400</u>

Subscriptions due the year ending 31st March, 2007 are Rs. 4,000.

Solution :

P.P. Sports Club
Income and Expenditure Account
for the year ended 31st March, 2007

<i>Expenditure</i>	<i>Rs.</i>	<i>Income</i>	<i>Rs.</i>
To Salary and Wages	12,000	By Members Subs-	
To Repairs	2,400	cription received	36,000
To Light	1,000	Add: Members	
To Entertainment	8,000	Subscription due	<u>4,000</u>
To Annual Programme	3,000		40,000
To Sundry expenses	1,000	By Misc. Receipts	3,000

To Excess of Income over Expenditure	19,600	By Annual Programme - Sale of tickets	4,000
	<u>47,000</u>		<u>47,000</u>

**P.P. Sports Club
Balance Sheet as on 31st March, 2007**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital Fund	10,400	Table Tennis Table	10,000
Add : Excess of Income over Expenditure	<u>19,600</u>	Billiards Table	8,000
	30,000	Glass and Cutlery	4,000
Add : Donations	<u>20,000</u>	Debtors	5,000
	50,000	Members' Subscriptions outstanding	4,000
Creditors	2,000	Cash in Hand	6,000
	<u>52,000</u>	Cash at Bank	15,000
			<u>52,000</u>

9. ACCOUNTING TREATMENT OF SPECIFIED ITEMS

There are certain items which are peculiar to non-trading concerns and require special treatment while preparing the final accounts of non-trading concerns.

(i) Subscriptions

Fixed periodical contributions required to be made by members of a non-trading institution to meet expenses are called subscriptions. Subscriptions form a major part of income of non-trading concerns and like any other income have to be allocated to the period in which they accrue. Normally calculations have to be made to ascertain the amount of subscriptions to be treated as the income of a particular year.

Illustration 3:

On 31st December, 2006 in a club subscriptions outstanding amounted to Rs. 2,200 and those received in advance for 2007 amounted to Rs. 600. Receipts and Payments Account of the club for the year ended 31st December, 2007 showed Rs. 55,600 as the total cash collection made on account of subscriptions during the year; out of this amount Rs. 2,000, related to 2006 and Rs. 800 related to 2008. On 31st December, 2007, it was found that subscriptions outstanding for 2007 amounted to Rs. 1,400.

Prepare Subscriptions Account for 2007 to find out the amount that will appear as income on account of subscriptions on the credit side of Income and Expenditure Account.

Solution:

<i>Dr.</i>	Subscriptions Account		<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
2007		2007	
Jan. 1	To Subscriptions Outstanding (as on 31.12.2006)	Jan. 1	By Subscriptions Received in Advance (for 2007)
	2,200		600
	<u>Rs.</u>		<u>Rs.</u>
Dec. 31	To Subscriptions	Dec. 31	By Cash (received

		Received in			during the year)	55,600
		Advance (for 2008)	800	" "	By Subscriptions	
Dec. 31	To	Income and			outstanding (as	
		Expenditure			on 31.12.2007)	
		A/c-transfer	54,800		For 2006	
					(2,200 – 2,000)	200
					For 2007	<u>1,400</u>
						<u>1,600</u>
			<u>57,800</u>			<u>57,800</u>

The same thing may be required to be done in respect of the some other item of income or expenditure. For this remember:

- (i) Income for the year
 - = cash received on account of income
 - plus* income received in advance as at the beginning of the year
 - plus* income accrued or due but not received as at the end of the year
 - minus* income accrued or due but not received as at the beginning of the year
 - minus* income received in advance for subsequent year as at the end of the year.
- (ii) Expenses for the year
 - = cash paid for the expenses
 - plus* prepaid-expense as at the beginning of the year
 - plus* outstanding expense as at the end of the year
 - minus* outstanding expense as at the beginning of the year
 - minus* prepaid expense as at the end of the year.

(ii) *Legacy* : It is the amount which a non-trading concern receives as per the will of a deceased person. It appears on the debit side of the receipts and payments account. It should be capitalised being an item of non-recurring nature and should be shown on the liabilities side of the balance sheet.

(iii) *Donations* : Donation is the amount received from some persons, firm, company or other body by way of gift. It appears on the debit side of the receipts and payment account. Donations may be of specific donations and general donations.

- (a) *Specific Donation* : In case the donation has been received for a specific purpose such as donation for library, donation for construction of building etc. it is capitalised and is shown on the liabilities side of the balance sheet irrespective of whether the amount is small or large. It is utilised only for the purpose for which it is meant.
- (b) *General Donation* : When the donor does not lay down any specific condition for using the amount of donation, it is termed as general donation. Its treatment depends upon the amount received. In case the donation is of a substantial amount it can be taken for granted that such donation is of a non-recurring nature and hence it should be capitalised and taken to the liabilities side of the balance sheet. However, if the donation is of small amount and not meant for any specific purpose, it should be treated as income and taken to the credit of income and expenditure account. Whether a donation is big or small would depend upon the circumstances of each case.

(iv) *Entrance Fees* : It may also be called as admission fees. This may be treated either as a revenue item or a capital item depending upon the nature, rules and by-laws of the organisations. In case the organisation collects fees from its members every year, it should be treated as revenue item and taken to the credit of income and expenditure account. However, if it is collected only for once from its members, the same should be treated as capital item and credited to the capital fund shown on the liabilities side of the balance sheet. Sometimes, the rules of the club provide that entrance fees should be partly treated as revenue receipt, then the relative portion should be credited to income and expenditure account and the balance to capital fund. In

the absence of clear instructions it should be preferably capitalized.

(v) *Special Funds* : Special funds are created for special purpose such as meeting any expense, acquiring any assets etc. It is created out of special subscription, donation or by appropriation of surplus. Any income derived from specific investment of the fund or any profit (loss) arising from the realisation of such investments should be added to that fund account. Similarly, all expenses on account of these funds should be deducted from these funds. Any balance remaining in the fund after the purpose is over, should be transferred to capital fund, or it may be maintained, if similar purpose is expected every year. However, if the concern receives any income on account of general fund or capital fund it should be treated as income and credited to income and expenditure account.

(vi) *Life Membership Fees* : There are some members who prefer to pay lumpsum amount instead of periodic payment for an estimated period of longevity known as life membership fees. The amount received as life membership fees can be treated in the accounts of the concern in any of the following ways:

- (a) The amount received may be taken as capital receipt and credited to life membership account which will be shown on the liabilities side of the balance sheet. On death of the member his contribution is transferred to capital fund.
- (b) The amount received may be credited to life membership account from which an amount equal to the normal annual subscription is transferred to income and expenditure account and the balance is carried forward till it is exhausted. In case of death of a member, the balance, if any, in the life membership account may be transferred to capital fund account.
- (c) The amount received may be credited to life membership account. Thereafter an amount calculated on the basis of the average life of the member is transferred annually to income and expenditure account and the balance is shown on the balance sheet.

(vii) *Sale of Old Assets* : Since sale of old asset is not an income, the same will not appear in the income and expenditure account, the sale proceeds will be deducted from the respective asset in the balance sheet. Only the profit or loss on sale of fixed assets shall be credited or debited as the case may be, to the income and expenditure account.

(viii) *Sale of Obsolete Items and Old News Papers* : Any amount realised from sale of such items should be taken on the debit side of the receipts and payments account and should be treated as items of income, hence, shown on the credit side of the income and expenditure account.

Illustration 4

The following are the Receipts and Payments Account of the Social Club in respect of the year ended 31st March, 2007.

<i>Receipts</i>	<i>Rs.</i>	<i>Payments</i>	<i>Rs.</i>
To Balance of cash on 1.4.2006	20,500	By Salaries	41,600
To Subscriptions:		By Stationery	8,000
2005-06	900	By Rates	12,000
2006-07	42,200	By Telephone	2,000
2007-08	<u>1,500</u>	By Investment	25,000
	44,600	By Sundry expenses	18,500
To Profit on sports meet	31,000	By Balance of cash	
To Income from investments	<u>20,000</u>	on 31.3.2007	<u>9,000</u>

1,16,100

1,16,100

The following additional information is provided to you :

- (i) There are 450 members each paying an annual subscription of Rs. 100; Rs. 1,000 were in arrears for 2005-06 as on 1st April, 2006.
- (ii) On 31st March, 2007 the rates were prepaid to 30th June, 2007; the charge paid every year being Rs. 12,000.
- (iii) There was an outstanding telephone bill for Rs. 700 on 31st March, 2007.
- (iv) Outstanding sundry expenses as on 31st March, 2006 totaled Rs. 1,400.
- (v) Stock of stationery on 31st March, 2006 was Rs. 1,000; on 31st March, 2007 it was Rs. 1,800
- (v) On 31st March, 2006, building stood in the books at Rs. 2,00,000 and it was subject to depreciation at 5% per annum.
- (vii) Investments on 31st March, 2006 stood at Rs. 4,00,000.
- (viii) On 31st March, 2007 income accrued on investments purchased during the year amounted Rs. 750.

Prepare an income and expenditure account for the year ended 31st March, 2007 and the balance sheet as at that date.

Solution:

**Social Club
Income and Expenditure Account
for the year ending 31.3.2007**

<i>Dr.</i>			<i>Cr.</i>		
<i>Rs.</i>			<i>Rs.</i>		
To Salaries		41,600	By Subscriptions		45,000
To Stationery stock	1,000		By Profit on sports meet		31,000
Add : Purchases	<u>8,000</u>		By Income on investments	20,000	
	9,000		Add : Income accrued	<u>750</u>	20,750
Less : Closing stock	<u>1,800</u>	7,200			
To Rates	12,000				
Less : Prepaid 2006-07	<u>3,000</u>				
	9,000				
Add : Prepaid 2005-06	<u>3,000</u>	12,000			
To Telephone	2,000				
Add : Outstanding	<u>700</u>	2,700			
To Sundry Expenses	18,500				
Less : Outstanding on 31.3.2006	<u>1,400</u>	17,100			
To Dep. on Bldg.		10,000			
To Surplus		<u>6,150</u>			
		<u>96,750</u>			<u>96,750</u>

**Social Club
Balance Sheet as on 31st March, 2007**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital Fund	6,24,100	Subscription in arrears	2,900
Add : Surplus for the year	<u>6,150</u>	Investments (4,00,000 + 25,000)	4,25,000
	6,30,250		
Subscription recd. in advance	1,500	Building	2,00,000
Outstanding telephone bill	700	Less : Dep.	<u>10,000</u>
			1,90,000
		Prepaid rates	3,000
		Stock of stationery	1,800
		Cash	9,000
		Income on investments accrued	<u>750</u>
	<u>6,32,450</u>		<u>6,32,450</u>

(i) Workings

<i>Dr.</i>	<i>Subscription A/c</i>	<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>
To Subscription in arrears (opening)	1,000	By Cash 44,600
To Subscription received in advance	1,500	By Subscription in arrears (closing-balancing figure) 2,900
To Income and Expenditure (Rs. 100 x 450) A/c	45,000	
	<u>47,500</u>	<u>47,500</u>

(ii) Balance Sheet as on 31st March, 2006

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Outstanding sundry expenses	1,400	Building	2,00,000
Capital Fund (Balancing figure)	6,24,100	Investments	4,00,000
		Stock of stationery	1,000
		Cash	20,500
		Prepaid rates	3,000
		Subscription in arrears	<u>1,000</u>
	<u>6,25,500</u>		<u>6,25,500</u>

Illustration 5

On 1st April, 2006 City Association received a donation of Rs. 1,00,000 for holding a tournament every year. The amount was immediately invested in 15% Debentures acquired at par, half yearly interest receivable on 30th September and 31st March. In the year ended 31st March, 2007, Rs. 10,960 were spent on tournament and in the final match, Rs. 2,080 were collected as gate receipts.

Show the necessary ledger accounts in the books of the association.

Solution:

<i>Dr.</i>	<i>Tournament Fund</i>	<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>
2007	2006	

Mar. 31	To Tournament Expenses	10,960	Apr. 1	By Bank	1,00,000
" "	To Balance c/d	1,06,120	2007 Mar. 31	By Interest on Tournament Fund Investment	15,000
			2007 Mar. 31	By Tournament Gate Receipts	2,080
		<u>1,17,080</u>			<u>1,17,080</u>
			2007 Apr. 1	By Balance b/d	1,06,120

Tournament Fund Investments Account

Dr.		Cr.
	Rs.	Rs.
2006 Apr. 1	To Bank	1,00,000
2007 Apr. 1	To Balance b/d	1,00,000
2007 Mar. 31	By Balance c/d	1,00,000

Interest on Tournaments Fund Investments Account

Dr.		Cr.
	Rs.	Rs.
2007 Mar. 31	To Tournament Fund A/c-transfer	15,000
2006 Sep. 30	By Bank	7,500
2007 Mar. 31	By Bank	7,500
	<u>15,000</u>	<u>15,000</u>

However, interest on General Fund Investments have to be shown on the credit side of Income and Expenditure Account. Further, the term 'Fund' should be used only when the amount collected is invested in securities or assets distinguishable from other assets belonging to the institution, otherwise the term 'Account' should be used. For example, if the amount of donation, received for specific purpose of tournament were not separately invested but mixed with other cash of institution, we would have credited the amount to Tournament Account and not to Tournament Fund Account as shown in the illustration just given. It follows from above that a 'Fund Account' is always accompanied by 'Investment Account'. If the question mentions, say Prize Fund Investment Account of Rs. 1,00,000 the students must assume that there is a Prize Fund of Rs.1,00,000 subject to anything given to the contrary and similarly if the question mentions, say Sports Fund of Rs. 50,000, an assumption must be made that there is Sports Fund Investment Account showing a balance of Rs. 50,000 provided there is nothing to the contrary given in the question.

Instead of paying cash, a donor may donate securities etc. In such a case the value of the asset on realisation or valuation must be credited to the Fund for which the securities have been donated.

The balances shown by Funds appear on the liabilities side of Balance Sheet whereas those shown by Funds Investments account appear on the asset side of Balance Sheet.

10. PREPARATION OF RECEIPTS AND PAYMENTS ACCOUNT WHEN LEDGER BALANCES AND OTHER INFORMATION ARE GIVEN

The following points may be kept in mind while preparing Receipts and Payments Account from ledger balances:

- (i) Opening balances of cash and bank are shown on the left side of the account.
- (ii) It includes receipts and payments both of revenue and capital nature.
- (iii) It includes receipts and payments even for preceding and succeeding years.
- (iv) Outstanding expenses are not shown in the Account.
- (v) Closing balances of Cash and Bank are shown on the right hand side of the Account.

Illustration 6 :

From the following informations, prepare a Receipts and Payments Account for the year ended 31st March, 2007:

Subscription realised for 2005-2006	40,000
Subscription realised for 2006-2007	2,00,000
Subscription to be realised for 2006-2007	15,000
Subscription received in advance for 2007-2008	10,000

Receipts :

Fee for coaching	20,000
Sundries	2,000
Sale of old newspapers	5,000
Donation for building	3,00,000

Payments :

Salaries	60,000
Repairs	15,000
Printing of stationery	10,000
Rates and taxes	15,000
Electricity	5,000
Construction of building	4,00,000
Newspapers	10,000

Cash in hand :

1.4.2006	10,000
31.3.2007	72,000

Outstanding expenses :

Repairs	2,000
Printing	5,000

Solution :

**Receipts and Payments Account
for the year ending 31st March, 2007**

Receipts	Rs.	Payments	Rs.
----------	-----	----------	-----

To Balance b/d	10,000	By Salaries	60,000
To Fee for coaching	20,000	By Repairs	15,000
To Sundries	2,000	By Printing of stationery	10,000
To Sale of old newspapers	5,000	By Rates and taxes	15,000
To Donation for building	3,00,000	By Electricity	5,000
To Subscriptions		By Construction of building	4,00,000
2005-06	40,000	By Newspaper	10,000
2006-07	2,00,000	By Balance c/d	72,000
2007-08	<u>10,000</u>		
	<u>5,87,000</u>		<u>5,87,000</u>
To Balance b/d	72,000		

11. PREPARATION OF RECEIPTS AND PAYMENTS ACCOUNT WHEN INCOME AND EXPENDITURE ACCOUNT, BALANCE SHEET AND OTHER INFORMATION ARE GIVEN

- (1) Preparation of Receipts and Payments Account from Income and Expenditure Account and the Balance Sheet requires finding out of cash receipts and cash payments received or made during the accounting year.
- (2) The items of expenditure are posted to the payments side whereas the items of income are posted to the receipts side of the Receipts and Payments Account.
- (3) The items of capital expenditure from balance sheet are posted to the payments side and items of capital receipts to the receipts side of the Receipts and Payments Account.
- (4) The closing balance on balancing of the Receipts and Payments Account will represent the closing balance of cash and bank at the end of the period.

Illustration 7 :

The following Income and Expenditure Account and Balance Sheet of Super Club are given below for the year ended on 31st March, 2007. You are required to prepare a Receipts and Payment Account of the Club for the related period.

Super Club **Income and Expenditure Account for the year ended 31.3.2007**

<i>Expenditure</i>	<i>Rs.</i>	<i>Income</i>	<i>Rs.</i>
To Opening Stock of Provisions	5,000	By Subscriptions	25,000
To Purchase of Provisions	40,000	By Donations	35,000
To Salaries	10,000	By Entrance Fee	5,000
To General Expenses	3,000	By Sale of Provisions	35,000
To Printing and Stationery	4,000	By Closing stock of Provisions	10,000
To Depreciation of Equipment	1,500		
To Excess of Income over Expenditure	<u>46,500</u>		
	<u>1,10,000</u>		<u>1,10,000</u>

Super Club
Balance Sheet as on 31st March, 2007

31.3.2006	Liabilities	Rs.	31.3.2006	Assets	Rs.
8,000	Creditors for Provisions	10,000	10,000	Equipment (written down value)	15,000
35,000	Capital Fund	81,500	5,000	Stock of Provisions	10,000
			23,000	Cash in Hand and at Bank	46,500
			5,000	Subscription Receivable	20,000
<u>43,000</u>		<u>91,500</u>	<u>43,000</u>		<u>91,500</u>

Solution :

Super Club
Receipts and Payments Account
for the year ended 31st March, 2007

Receipts	Rs.	Payments	Rs.
To Cash in Hand and Bank (opening balance)	23,000	By Purchase of Provisions	38,000
To Subscription	10,000	By Salaries	10,000
To Donation	35,000	By Printing and Stationery	4,000
To Entrance Fee	5,000	By General Expenses	3,000
To Sale of Provisions	35,000	By Equipment Purchased	6,500
		By Cash in Hand and at Bank (closing balance)	46,500
	<u>1,08,000</u>		<u>1,08,000</u>

Working Notes:

1. *Payment to Creditors for Provisions :*

	Rs.
Opening Balance	8,000
Add : Purchases during the year	40,000
	48,000
Less : Closing balance	10,000
	<u>38,000</u>

2. *Subscriptions :*

As per Income and Expenditure Account	25,000
Add : Subscription for 2005-06	5,000
	30,000
Less : Subscription for 2006-07	20,000
	<u>10,000</u>

3. *Equipment Purchased :*

Closing balance of Equipment	15,000
Add : Depreciation written off	<u>1,500</u>

	16,500
Less : Opening balance of equipment	<u>10,000</u>
	<u>6,500</u>

Illustration 8

From the following particulars relating to Nath Charitable Clinic, prepare:

- (i) receipts and payments account for the year ended on 31st March, 2007; and
- (ii) balance sheet as on 31st March, 2007:

**Income and Expenditure Account
for the year ended 31st March, 2007**

Expenditure	Rs.	Income	Rs.
To Medicines used	2,99,800	By Subscriptions	5,60,000
To Honorarium to doctors	1,20,000	By Donations	95,000
To Salaries	2,75,000	By Interest on investments	
To Printing and stationery	11,000	@ 11% per annum	1,10,000
To Electricity	4,750	By Income from film show:	
To Rent	60,000	Proceeds	1,14,500
To Depreciation on furniture	21,000	Less : Expenses	<u>7,800</u>
To Depreciation on equipment	32,500		1,06,700
To Surplus, i.e. excess of income over expenditure	<u>47,650</u>		
	<u>8,71,700</u>		<u>8,71,700</u>

Additional information :

	On 1.4.2006	On 31.3.2007
(i) Subscription due	1,200	1,600
(ii) Subscriptions received in advance	640	1,000
(iii) Electricity bills unpaid	920	1,150
(iv) Stock of medicines	78,200	97,500
(v) Estimated value of equipment	1,16,000	1,39,000
(vi) Furniture and fixture	2,10,000	1,89,000
(vii) Land	1,00,000	
(viii) Interest accrued on investments in 11% debentures costing Rs. 10,25,000 (face value: Rs. 10,00,000)	37,500	37,500
(ix) Cash in hand	3,400	1,600
(x) Cash at bank	90,000	?

Solution :

**Nath Charitable Clinic
Receipts and Payments Account
for the year ended 31st March, 2007**

<i>Dr.</i>			<i>Cr.</i>
<i>Receipts</i>	<i>Rs.</i>	<i>Payments</i>	<i>Rs.</i>
To Balance b/d		By Medicines	3,19,100
Cash in hand	3,400	By Hon. to Doctors	1,20,000
Cash at bank	90,000	By Salaries	2,75,000
To Subscriptions	5,59,960	By Printing and Stationery	11,000
To Donations	95,000	By Electricity	4,520
To Interest on Investment received	1,10,000	By Rent	60,000
Add : Accrued of current year	37,500	By Equipment	55,500
Less : Accrued of last year	(37,500)	By Expenses on Film Show	7,800
	1,10,000	By Land	1,00,000
To Proceeds from		By Cash in hand	1,600
Film Show	1,14,500	By Cash at Bank	18,340
		(balancing figure)	
	<u>9,72,860</u>		<u>9,72,860</u>

Nath Charitable Clinic
Balance Sheet as on 31st March, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Subscriptions received in advance	1,000	Land	1,00,000
Electricity charge due	1,150	Furniture	2,10,000
Capital Fund:		Less: Depreciation	(21,000)
Opening balance	15,59,740	Equipment	1,39,000
Add: Surplus	<u>47,650</u>	Investment	
	16,07,390	(11% Debentures)	10,25,000
		Interest accrued	37,500
		Stock of medicines	97,500
		Subscription due	1,600
		Cash in hand	1,600
		Cash at bank	<u>18,340</u>
	<u>16,09,540</u>		<u>16,09,540</u>
	-----		-----

Working Notes :

(1) <i>Subscriptions received :</i>	<i>Rs.</i>	<i>Rs.</i>
Subscription during the year	5,60,000	
Add : Subscription outstanding last year	1,200	
Subscription received in advance current year	<u>1,000</u>	
	5,62,200	
Less : Subscription outstanding current year	(1,600)	
Subscription received in advance last year	<u>(640)</u>	5,59,960

(2) <i>Medicines purchased :</i>		

Medicines used	2,99,800
Add : Stock of current year	97,500
Less : Stock of last year	(78,200)

	3,19,100

(3) *Payment to Electricity Bill :*

Electricity charges	4,750
Add : Outstanding last year	920
Less : Outstanding current year	(1,150)

	4,520

(4)

<i>Dr.</i>	Equipment A/c		<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
To Balance b/d	1,16,000	By Depreciation A/c	32,500
To Cash purchases	55,500	By Balance c/d	1,39,000
	-----		-----
	1,71,500		1,71,500
	-----		-----

(5) **Balance Sheet as on 1.4.2006**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Subscriptions received		Furniture and fixtures	2,10,000
in a advance	640	Equipment	1,16,000
Electricity		11% Debentures	10,25,000
charges due	920	Stock of medicines	78,200
Capital fund	15,59,740	Interest accrued	37,500
(balancing figure)		Subscription due	1,200
		Cash in hand	3,400
		Cash at bank	90,000
	-----		-----
	15,61,300		15,61,300
	-----		-----

12. PREPARATION OF BALANCE SHEET WHEN RECEIPTS AND PAYMENTS ACCOUNT AND INCOME AND EXPENDITURE ACCOUNT ARE GIVEN

In examination, sometimes the Receipts and Payments Account and the Income and Expenditure Account of an institution are given alongwith some other information and the candidates are asked to prepare the Balance Sheet. The main thing to note for such a question is that items in the two 'accounts' should be compared one by one - items on receipts side of Receipts and Payments Account should be compared with those appearing on income side of Income and Expenditure Account and items appearing on payments side of Receipts and Payments Account should be compared with items appearing on expenditure side of Income and Expenditure Account. The comparison will reveal outstanding expenses, expenses paid in

advance, income received in advance, income accrued but not yet received, increases and decreases in various fixed assets, depreciation, cash in hand and at bank at the end of the year surplus or deficiency for the year, etc. Such information along with other information specifically given in the question will enable one to prepare Balance Sheet.

Illustration 9

From the following Receipts and Payments Account and the Income and Expenditure Account of Delhi Club prepare a Balance Sheet as on 31.3.2006 and 31.3.2007.

Delhi Club
Receipt and Payments Account for the year
ended 31st March, 2007

<i>Receipts</i>	<i>Rs.</i>	<i>Payments</i>	<i>Rs.</i>
To Opening Balance	1,60,000	By Salaries	2,40,000
To Endowment	80,000	By Advertisement	48,000
To Subscription	4,08,000	By Printing and Stationery	28,000
To Entrance Fee	32,000	By Sports Material	1,12,000
To Donation for Books	52,000	By Creditors	
To Entertainment	1,60,000	(Standing on 31.3.2006)	52,000
To Sale of Furniture	28,000	By Investment @ 12%	80,000
(Cost price 32,000)		(Purchased on 1.7.2006)	
		By Provisions	2,72,000
		By Bank Deposit	40,000
		By Closing Balance	48,000
	<u>9,20,000</u>		<u>9,20,000</u>

Delhi Club
Income and Expenditure Account for the year
ended 31st March, 2007

<i>Expenditure</i>	<i>Rs.</i>	<i>Income</i>	<i>Rs.</i>
To Loss on sale of furniture	4,000	By Subscription	4,00,000
To Salaries	2,68,000	By Entrance fee	16,000
To Advertisement	40,000	By Interest on investment	7,200
To Audit Fee	12,000	(9 months)	
To Provisions	2,40,000	By Entertainment	1,60,000
To Printing and Stationery	30,000	By Excess of Expenditure	
To Sports Material	80,000	over Income	90,800
	<u>6,74,000</u>		<u>6,74,000</u>

Solution:

Delhi Club
Balance Sheet as on 31st March, 2006

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Creditors	52,000	Cash in hand	1,60,000
Capital Fund		Furniture	32,000

(Balancing Figure)	<u>1,40,000</u>	
	<u>1,92,000</u>	<u>1,92,000</u>

Delhi Club
Balance Sheet as on 31st March, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Subscription received in advance	8,000	Cash in hand	48,000
Outstanding Audit Fee	12,000	Cash at bank	40,000
Outstanding Salaries	28,000	Stock of Sports Material	32,000
Outstanding Printing and Stationery	2,000	Investment	80,000
Endowment	80,000	Interest accrued	7,200
Donation for books	52,000	Prepaid Advertisement	8,000
Capital Fund	1,40,000	Provisions	32,000
Add : 50% Entrance Fee	16,000		

	1,56,000		
Less : Excess of Expenditure over Income	90,800		

	2,47,200		

			2,47,200

- Note :** 1. 50% of the entrance fee has been treated as revenue income.
2. The difference in subscription has been treated as subscription received in advance at the end of the year. The difference may also be taken as subscription outstanding at the beginning of the year.

13. Receipts and Expenditure Account

Professional people like solicitors, doctors, chartered accountants, etc., prepare for themselves Receipts and Expenditure Account which is a modified form of Income and Expenditure Account prepared by non-trading concerns. In Receipts and Expenditure Account, even outstanding expenses find place as usual in Profit and Loss Account and Income and Expenditure Account but professional income which has accrued but has not been received is not considered to be the income of the year in which it accrues or becomes due. This is because professional people do not file suit for recovery of their dues. In Receipts and Expenditure Account, the total income including that which has accrued or has become due but has not been received in cash is shown on the credit side but the 'account' is debited with a provision for outstanding income. In short, in Receipts and Expenditure Account income is determined on cash basis and expenditure on accrual basis. In the Balance Sheet the income yet to be collected is shown on the assets-side, deducting the provisions of an equal amount from the same thus giving zero as the net amount.

Illustration 10 :

Dr. Mehta commenced his practice from 1.1.2007. His Receipts and Payments Account for

the year is as follows. You are required to prepare Receipts and Expenditure Account for the year 2007 and balance sheet as at that period.

Dr. Mehta
Receipts and Payments Account for the year ended 31.12.2007

<i>Receipts</i>	<i>Rs.</i>	<i>Payments</i>	<i>Rs.</i>
To Cash brought in	2,00,000	By Furniture	1,00,000
To Visiting fees	4,00,000	By Purchase of drugs	80,000
To Receipts from dispensing	1,50,000	By Salary of compounder	55,000
To Misc. Receipts	5,000	By Rent	48,000
		By Conveyance	24,000
		By Lighting	6,000
		By Drawings	2,40,000
		By Balance c/d	2,02,000
	-----		-----
7,55,000		7,55,000	
	-----		-----

Amount receivable on account of visits and dispensing are Rs. 20,000 and Rs. 15,000 respectively. Amount payable on account of purchase of drugs is Rs.10,000. Stock of drugs in hand is Rs. 20,000. Salary of compounder payable is Rs. 5,000. 40% of conveyance is for domestic purposes. Furniture is subject to depreciation at 10%.

Solution:

Dr. Mehta
Receipts and Expenditure Account for the year ended 31.12.2007

<i>Expenditure</i>	<i>Rs.</i>	<i>Receipts</i>	<i>Rs.</i>
To Drugs	80,000	By Visiting fees	4,00,000
Add : Outstanding	<u>10,000</u>	Add : Outstanding	<u>20,000</u>
	90,000		4,20,000
Less : Stock in hand	<u>20,000</u>	By Dispensing	1,50,000
	70,000	Add : Outstanding	<u>15,000</u>
To Salary of Compounder	55,000	By Misc. Receipts	5,000
Add : Outstanding	<u>5,000</u>		
	60,000		
To Rent	48,000		
To Lighting	6,000		
<i>Expenditure</i>	<i>Rs.</i>	<i>Receipts</i>	<i>Rs.</i>

To Depreciation	10,000
To Provision for Outstanding Receipts	35,000
To Conveyance	24,000
Less: 40% for Domestic use	9,600
	14,400

To Surplus	----- 3,46,600	
	-----	-----
	5,90,000	5,90,000
	-----	-----

Dr. Mehta
Balance Sheet as on 31.12.2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Expenses outstanding:		Furniture	1,00,000
Purchase of drugs	10,000	Less : Depreciation	<u>10,000</u> 90,000
Salary	5,000	Outstanding Income	35,000
Capital	2,00,000	Less : Provision for	
Add : Surplus	<u>3,46,600</u>	outstanding	<u>35,000</u> —
	5,46,600	Cash in hand	2,02,000
Less : Drawings	2,49,600	Stock of Drugs	20,000
	-----		-----
	3,12,000		3,12,000
	-----		-----

SELF-TEST QUESTIONS

1. Distinguish between Receipts and Payments Account and Income and Expenditure Account.
2. What do you understand by non-trading or non-profit concerns? What are the chief characteristics of their accounts?
3. What steps will you take to prepare Income and Expenditure Account on the basis of Receipts and Payments Account?
4. How will you treat the following items in the final accounts of a non-trading concerns.
 - (a) Subscriptions
 - (b) Donations
 - (c) Life membership fee
 - (d) Entrance fee
 - (e) Subscriptions for party to minister
 - (f) Promise received for donation
 - (g) Outstanding subscription for party to minister
 - (h) Interest received on Sports Fund Investments
 - (i) Sale proceeds of tickets for a variety show
 - (j) Amount of entertainment tax included in the sale proceeds of tickets for the variety show.
5. State which of the following statements are false:
 - (a) Receipts and Payments Account is summary of Cash Book.
 - (b) Statement of Affairs is as reliable as Balance Sheet.
 - (c) Income and Expenditure Account takes the place of Profit and Loss Account in non-trading concerns.
 - (d) Professional men do not make credit for outstanding income.

[Ans. (b) is false]

6. Distinguish between Receipts and Expenditure Account and Income and Expenditure Account.
7. From the following particulars, prepare the income and expenditure account of the General Sports Club for the twelve months from April 2006 (date of inception) to 31st March, 2007:

	<i>Received/Paid</i> <i>Rs.</i>	<i>Outstanding</i> <i>Rs.</i>
Subscriptions from members	46,000	–
Subscription from affiliated societies	14,000	2,000
Life subscriptions for 10 years	20,000	–
Gifts received	30,000	–
Interest received	1,600	–
Committee expenditure:		
Executive	15,000	2,000
Planning	14,400	6,400
Tournament	4,200	1,200
Printing, postage and stationery	11,400	1,600
Office furniture	20,000	–
Investment purchases	30,000	–

8. From the following data, prepare Receipts and Expenditure Account for the year ended 31st December, 2007 and a Balance Sheet as at that date for Dr. Ranjan, a medical practitioner.

	<i>Rs.</i>
Fees received during the year	1,37,400
Cash receipts at the dispensary counter	3,24,200
Cash paid for medicines, rent, etc.	3,13,600

In the figure of Rs. 1,37,400, included a sum of Rs. 400 pertaining to December, 2007 but received in January, 2008. On 31st December, 2007 Dr. Ranjan finds that Rs. 140 are due from a patient for medicine for four days. Stock of medicine on 1st January, 2007 was valued at Rs. 13,000 and the same is valued at Rs. 10,200 on 31st December, 2007.

A sum of Rs. 1,000 is found due to a chemist for medicines supplied by him in December, 2007. Furniture and Equipment is valued at Rs. 2,10,000 after providing a depreciation of Rs. 20,000 for the year 2007. On 31st December, cash in hand and at bank amounted Rs. 39,800.

9. The following are the Receipts and Payments Account and Income and Expenditure Account of a newly started club. Prepare Balance Sheet as at 31st December, 2007.

**Receipts and Payments Account
for the year ended 31st December, 2007**

	<i>Rs.</i>		<i>Rs.</i>
To Donations	2,00,000	By Investments	1,00,000
To Entrance Fee	8,000	By Rent	36,000
To Subscriptions	40,000	By Salaries	30,000
To Interest on Investments	800	By Insurance Premium	800

	By Expenses on Sports	16,000
	By Furniture	40,000
	By Sundry Expenses	10,600
	By Cash in hand	<u>15,400</u>
<u>2,48,800</u>		<u>2,48,800</u>

**Income and Expenditure Account
for the year ended 31st December, 2007**

	Rs.		Rs.
To Rent	36,000	By Subscriptions	48,000
To Salaries	36,000	By Interest on Investments	8,100
To Insurance Premium	600	By Deficit i.e. excess of	
To Expenses on Sports	16,000	expenditure over income	48,100
To Sundry Expenses	11,600		
To Audit Fee	1,000		
To Depreciation on Furniture	<u>3,000</u>		
	<u>1,04,200</u>		<u>1,04,200</u>

[Ans. Balance Sheet Rs. 1,67,900]

10. Following is the Income and Expenditure Account of the Vishnu Charity Hospital for the year 2007 :

(Rs. in '000)

Expenditure	Rs.	Income	Rs.
To Salaries	23,500	By Subscriptions	22,000
To Diet Expenses	2,000	By Donations	4,600
To Rent and Rates	500	By Interest on Investments	
To Insurance	200	for full year @ 6% p.a.	9,000
To Surgery and Dispensary Expenses	1,800		
To Depreciation on:			
Building	3,750		
Furniture	120		
Instruments	<u>800</u>		
	4,670		
To Surplus of Income over Expenditure	<u>2,930</u>		
	<u>35,600</u>		<u>35,600</u>

(Rs. in '000)

Other information supplied to you is as under:

			Rs.
Cash in hand	on	1.1.2007	200
Cash at Bank	"	"	5,400
Buildings	"	"	75,000

Furniture	"	"	2,000
Instruments	"	"	3,500
Subscriptions outstanding	"	"	1,500
Salaries outstanding	"	"	1,800
Subscriptions received in advance	"	"	600
Subscriptions received in advance	"	31.12.2007	800
Subscriptions outstanding	"	"	4,500
Salaries outstanding	"	"	2,000
Cash in hand	"	"	150
Instruments purchased during the year	"	"	500

Prepare Receipts and Payments Account for the year ended 31st December, 2007 and the Balance Sheet of the hospital as on that date.

11. From the following particulars relating to Ramkrishna Mission Charitable Hospital, prepare Income and Expenditure Account for the year ended 31st March, 2007 and Balance Sheet as at that date:

**Receipts and Payments Account
for the year ended 31st March, 2007**

(Rs. in '000)

<i>Receipts</i>	<i>Rs.</i>	<i>Payments</i>	<i>Rs.</i>
To Cash in hand on (1.4.2006)	7,130	By Medicines	30,590
To Subscriptions	47,996	By Doctors' Honorarium	9,000
To Donations	14,500	By Salaries	27,000
To Interest on investments @ 8% for full year	8,000	By Petty Expenses	961
To Proceeds from Charity Show	<u>11,450</u>	By Equipment	15,500
	<u>89,076</u>	By Expenses on Charity Show	750
		By Cash in hand on (31.3.2007)	<u>5,275</u>
			<u>89,076</u>

(Rs. in '000)

<i>Additional Information</i>	<i>1.4.2006</i>	<i>31.3.2007</i>
(i) Subscriptions due	240	280
(ii) Subscriptions received in advance	64	100
(iii) Stock of Medicines	9,730	9,990
(iv) Estimated value of Equipment	22,200	33,600
(v) Buildings (cost less depreciation)	50,000	47,000

12. Royal Library Society showed the following position on 31st March, 2007:

Balance Sheet as on 31st March, 2006

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital fund	7,93,000	Electrical fittings	1,50,000
Expenses payable	7,000	Furniture	50,000
		Books	4,00,000
		Investment in securities	1,50,000
		Cash at bank	25,000
		Cash in hand	25,000
	<u>8,00,000</u>		<u>8,00,000</u>

The Receipts and Payments Account for the Year ended on 31st March, 2007 is given below :

Receipts and Payment Account for the year ended 31st March, 2007

<i>Receipts</i>	<i>(Rs.)</i>	<i>Payments</i>	<i>(Rs.)</i>
To Balance b/d		By Electric charges	7,200
Cash at bank	25,000	By Postage and stationery	5,000
Cash at hand	<u>25,000</u>	By Telephone charges	5,000
	50,000	By Books purchased	60,000
To Entrance fees	30,000	By Outstanding expenses paid	7,000
To Membership subscription	2,00,000	By Rent	88,000
To Sale proceeds of old papers	1,500	By Investment in securities	40,000
To Hire of lecture hall	20,000	By Salaries	66,000
To Interest on securities	8,000	By Balance c/d	
		Cash at bank	20,000
		Cash in hand	<u>11,300</u>
	<u>3,09,500</u>		<u>3,09,500</u>

You are required to prepare an Income and Expenditure Account for the year ended 31st March, 2007 and a Balance Sheet as at 31st March, 2007 after making the following adjustments:

- (i) Membership subscription included Rs. 10, 000 received in advance.
- (ii) Provide for outstanding rent Rs. 4,000 and salaries Rs. 3,000.
- (iii) Books to be depreciated @ 10% including additions. Electrical fittings and furniture are also to be depreciated at the same rate.
- (iv) 75% of the entrance fees is to be capitalized.
- (v) Interest on securities is to be calculated @ 6% p.a. including purchase made on 1.10.2006 for Rs. 40,000

Suggested Readings :

- (1) *J.R. Monga* — Advanced Financial Accounting
- (2) *S.P. Jain & K.L. Narang* — Financial Accounting
- (3) *M.C. Shukla, T.S. Grewal and S.C. Gupta* — Advanced Accounts, Vol. I
- (4) *S.N. Maheshwari* — Financial Accounting
- (5) *Ashok Sehgal & Deepak Sehgal* — Financial Accounting

STUDY IX

SINGLE ENTRY ACCOUNTS

1. MEANING OF SINGLE ENTRY SYSTEM

Kohler (Dictionary for Accountants) defines single entry system as “a system of book-keeping in which as a rule only records of cash and personal accounts are maintained; it is always incomplete double entry, varying with circumstances.” Thus, single entry system actually refers to incomplete records or defective double entry system. Under this system, both aspects of certain transactions are recorded while only one aspect is recorded for certain transactions. In other words, a business is said to be using single entry system of accounting when it is not following fully the principle of double entry system of accounting.

Under double entry system, both the aspects of every transaction are recorded in the books of account. Hence, one may conclude that single entry system must be a system in which only one aspect of every transaction is recorded. But this is a wrong conclusion. Actually, single entry system is not the name given to any definite system but it refers rather to a lack of system. Under single entry system a business house keeps the record which it considers to be absolutely essential for itself; the actual system will differ from case to case. Under this system, some transactions like cash received from trade debtors and cash paid to trade creditors may be recorded in the same manner in which they are recorded under double entry system, i.e. both the aspects of some transactions may be recorded. Only one aspect of certain other transactions (like payment of cash for various expenses) may be recorded whereas no record may be made for the remaining transactions (like depreciation on assets). Thus, no uniform principle is applied to treat transactions.

However, Cash Book is maintained in most of the cases. The personal accounts of trade debtors and trade creditors are also usually maintained to ascertain the amounts due from different customers and those payable to different suppliers although a firm may choose to fulfil this object by means of invoices received from suppliers and copies of invoices sent to customers; the invoices for which payment has been received or made are marked with the date of payment along with the mode of payment, receipt no. etc., the unmarked invoices kept separately will reveal the amounts due to suppliers and those due from customers. Mostly no real and nominal accounts are maintained. Consequently a physical inspection has to be made to ascertain the assets of the business and Cash Book has to be analysed to get an idea of various expenses and sources of income.

As Cash Book is maintained, at least one aspect of all cash transactions is recorded. If the accounts of trade debtors and trade creditors are also maintained, cash transactions with them are recorded i.e. both aspects. Credit sales and credit purchases and returns are recorded in personal accounts but no Purchases Account, Sales Account, Sales Returns Account or Purchases Returns Account is maintained. Similarly, acceptances (of bills) are recorded in personal accounts and payments for them on maturity are recorded in Cash Book but no Bills Receivable Account or Bills Payable Account is maintained. But the biggest defect of this system is that no record is made for a very large number of transactions like outstanding expenses, income received in advance, depreciation on fixed assets, etc.

This system of single entry is developed by certain business houses for their convenience and for more practical approach; they reject strict rules of the double entry system and maintain only bare essential records. Small merchants, professionals etc. usually adopt this system. Joint stock companies cannot adopt single entry system as they are required to maintain the accounts as per the Companies Act, 1956.

2. SALIENT FEATURES OF SINGLE ENTRY SYSTEM

- (i) *Maintenance of personal accounts* : Usually under this system, personal accounts are maintained while real and nominal accounts are avoided.
- (ii) *Maintenance of cash book* : A cash book is maintained which usually mixes up both personal transaction and business transaction.
- (iii) *Dependence on original vouchers* : In order to collect the necessary information, the original vouchers are referred.
- (iv) *No uniformity* : The application of this system may differ from firm to firm as per its individual requirements and convenience.
- (v) *Similarity*: The system is suitable in case of small proprietary or partnership concerns.

3. DIFFERENCE BETWEEN DOUBLE ENTRY SYSTEM AND SINGLE ENTRY SYSTEM

- (i) *Record of Transactions* : Under double entry system, both the aspects i.e. debit and credit, of all the transactions are recorded. Under single entry system, there is no record of some transactions, some transactions are recorded only in one of their aspects whereas some other transactions are recorded in both of their aspects.
- (ii) *Subsidiary Books* : Under double entry system, various subsidiary books like sales book, purchases book, etc. are maintained. Under single entry system, no subsidiary books except cash book which is also considered as a part of ledger is maintained.
- (iii) *Ledger Accounts* : Under double entry system, there is a ledger which contains personal, real and nominal accounts. But under single entry system the ledger contains some personal accounts only.
- (iv) *Trial Balance* : Under double entry system, preparation of trial balance is possible. It is not possible to prepare a trial balance under the single entry system. Hence accuracy of work is uncertain.
- (v) *Final Accounts* : Under double entry system trading and profit and loss account and balance sheet are prepared in a scientific manner. Under single entry system it is not possible; only a rough estimate of profit or loss is made and a statement of affairs is prepared which resembles balance sheet in appearance but which does not present an accurate picture of the financial position of the business.
- (v) *User* : Single entry system is used only by very small business units; all others employ double entry system.

4. ADVANTAGES OF SINGLE ENTRY SYSTEM

- (i) Single entry is a simple method of recording business transactions.
- (ii) It is mainly suited to small business concerns with limited number of transactions.
- (iii) Under single entry system, accounting records can easily be maintained as their maintenance does not require any adequate knowledge of the principles of book keeping.
- (iv) It is comparatively less expensive than double entry system of book keeping,
- (v) Ascertainment of profit or loss is much easier. It is ascertained by comparing the financial position of the business at the close of the accounting period with that at the beginning.

5. LIMITATIONS OF SINGLE ENTRY SYSTEM

- (i) As the system does not record both the aspects of a large number of transactions, the arithmetical accuracy of the books cannot be checked by preparing a trial balance. It encourages the possibility of frauds, carelessness and misappropriations.

- (ii) In the absence of complete information of sales, purchases and other information, it is not possible to prepare the profit and loss account. Hence true profit or loss made or suffered by the business cannot be known.
- (iii) In the absence of correct information of profit or loss and that of the assets and liabilities of the business, the balance sheet cannot be drawn to give a correct picture of the financial position of the business on a particular date.
- (iv) As the system does not provide accurate figures about the performance of the business and its financial position, it becomes difficult for the proprietor to plan and to take decisions.
- (v) No correct price of the business is available. This is a stumbling block at the time of sale of the business.
- (vi) As the system does not result in a proper and reliable balance sheet, it becomes difficult to get loans from banks and financial institutions.
- (vii) Financial strength or soundness of the firm cannot be judged because true and reliable figure of net profit or assets and liabilities is not available.
- (viii) Courts, income tax authorities, insurance companies, etc, do not accept accounts prepared on the basis of single entry system.
- (ix) It is not possible to attempt intra-firm and inter-firm comparisons since necessary statistical information needed for the purpose is not available.

6. STATEMENT OF AFFAIRS

Statement of affairs is a statement of assets and liabilities of a business on a particular date. It is virtually the balance sheet of the business and has got two sides, assets side and liabilities side. All the assets of the business are listed on the assets side. The amount of cash in hand, cash at bank and those due from debtors appear at their correct figure but all other assets are shown at their estimated values. Liabilities to outsiders are placed on the liabilities side. The difference between total assets and outside liabilities is the capital which is also placed on the liabilities side. A Statement of Affairs may be prepared as under:

Statement of Affairs as on _____

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Creditors		Cash	
Bank Overdraft		Stock	
Capital(balancing figure)		Debtors	
		Furniture	
		Machinery	
		Building	

7. DISTINCTION BETWEEN STATEMENT OF AFFAIRS AND BALANCE SHEET

- (i) Statement of affairs is prepared from ledger balance and partly from other particulars and estimates, etc. but a balance sheet is prepared from the ledger accounts only.
- (ii) In case of balance sheet, capital account is taken from the ledger whereas in case of statement of affairs, capital is the excess of assets over liabilities.
- (iii) In statement of affairs, accuracy cannot be assumed, however, accuracy can be assumed in a balance sheet.
- (iv) Omission of assets and liabilities cannot be traced easily in a statement of affairs, but in balance sheet omission of an item can be easily located since in such situations, both sides of the balance sheet will not tally.

- (v) The values of assets are arbitrary in a statement of affairs while in a balance sheet the balance of any asset or liability can be taken as true as the relevant transactions are posted in the respective accounts of general ledger.
- (vi) The primary purpose of balance sheet is to show the financial position of the business on a particular date. But a statement of affairs prepared shows the financial position as well as it helps in ascertaining the trading profit or loss for a particular period.

8. ASCERTAINING PROFIT BY STATEMENT OF AFFAIRS METHOD

The profit in case of a business organisation maintaining accounts according to single entry system can be ascertained by two methods i.e. (i) Net worth method and (ii) Conversion method.

In the accounting parlance, profit of an organization can be ascertained by calculating the difference between closing capital and opening capital. Ascertainment of profit of an organization by Statement of Affairs Method is also known as Net Worth Method. According to this method, the profit or loss made by the business is computed by comparing the net worth (capital) of the business on two different dates i.e. at the beginning and at the end of the year. The following procedure is followed in this regard:

1. *Calculation of Capital at the beginning* : For this purpose a statement of Affairs is prepared for the beginning of the period. The balancing figure is treated as capital at the beginning of the period.
2. *Calculation of Capital at the end* : For this purpose also a Statement of Affairs is prepared for the end of the year and the balancing figure is treated as capital at the end.
3. *Adjustment of Capital at the end* : For this purpose, drawing made during the year is added to the capital at the end and deduct there from the additional capital introduced during the year. Drawings are added to the capital at the end because any drawings made during the year can reduce capital at the end but not profit. The fresh capital introduced is deducted from the capital at the end because any increase in capital at the end due to introduction of capital during the year is not an increase in capital due to profits made during the year.
4. *Calculate the difference* : The difference between adjusted capital at the end and capital in the beginning is either profit or loss made during the period. If the adjusted capital at the end is more than at the beginning it is treated as profit. While, if the result is negative i.e. if the opening capital is more than the adjusted closing capital, it will mean that there has been a loss.

Profit can be ascertained as follows:

Take capital at the end of the year	xxx
Add : Drawings made by the proprietor during the year	<u>xxx</u>
	xxx
Less : Fresh capital introduced during the year.	<u>xxx</u>
	xxx
Less : Capital in the beginning of the year.	<u>xxx</u>
Profit earned during the year	<u>xxx</u>

Profit = [Capital at the end + Drawings – Additional Capital Introduced] – Capital in the beginning.

Illustration 1

Nandu maintains his books by single entry system. From the following particulars regarding his assets and liabilities and additional information provided to you, ascertain the profit earned by him during 2007.

On 1st

On 31st

	<i>Jan., 2007</i>	<i>Dec., 2007</i>
	<i>Rs.</i>	<i>Rs.</i>
Cash	10,100	11,180
Stock	1,11,650	1,28,150
	<i>Rs.</i>	<i>Rs.</i>
Debtors	40,750	51,300
Furniture	50,000	—
Creditors	72,400	69,400

Furniture is depreciated by Nandu @ 10% p.a. on diminishing balance method. Nandu withdraws every month Rs. 5,000 for his household expenses.

Solution :

**Statement of Affairs of Nandu
as on 1st January , 2007**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Creditors	72,400	Cash	10,100
Capital	1,40,100	Stock	1,11,650
(Balancing figure)		Debtors	40,750
		Furniture	<u>50,000</u>
	<u>2,12,500</u>		<u>2,12,500</u>
	-----		-----

**Statement of Affairs of Nandu
as on 31st December, 2007**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Creditors	69,400	Cash	11,880
Capital	1,66,930	Stock	1,28,150
(Balancing figure)		Debtors	51,300
		Furniture	50,000
		Less: Depreciation	<u>5,000</u>
	<u>2,36,330</u>		<u>45,000</u>
	-----		<u>2,36,330</u>

Statement showing profit for the year ended 31st December, 2007

Capital as on 31st December, 2007	1,66,930
Add : Drawing made during the year	
5,000 x 12 = 60,000	<u>60,000</u>
	2,26,930
Less : Capital as on 1st January, 2007	<u>1,40,100</u>
Profit for the year	<u>86,830</u>

Illustration 2

Ramesh had Rs. 3,00,000 in bank on 1st January, 2006 when he started his business. He closed his accounts on 31st March, 2007. His single entry books (in which he did not maintain any account for the bank) showed his position as follows:

31.3.2006

31.3.2007

	Rs.	Rs.
Cash in hand	2,000	3,000
Stock in trade	19,000	29,000
Debtors	1,000	2,000
Creditors	5,000	3,000

On 1st April, 2006, he began drawing Rs. 700 per month for his personal expenses from the Cash Book of the business. His account in the bank had the following entries:

	Deposits	Withdrawals
1.1.2006	3,00,000	-
1.1.2006 to 31.3.2006	-	2,23,000
1.4.2006 to 31.3.2007	2,30,000	2,70,000

The above withdrawals included payments by cheques of Rs. 2,00,000 and Rs. 60,000 respectively during the period from 1st January, 2006 to 31st March, 2006 and on 1st March, 2007 for the purchase of machinery for the business. The deposits after 1st January, 2007 consisted wholly of sale price received from customers by cheques.

Draw up Ramesh's Statement of Affairs as at 31st March, 2006 and 31st March, 2007 respectively and work out his profit or loss for the year ended 31st March, 2007.

Solution:

Ascertainment of Opening Capital (as on 31.3.2006)

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	5,000	Cash in hand	2,000
Capital (balancing figure)	2,94,000	Cash at bank	3,00,000
		Less: Withdrawals	<u>2,23,000</u>
		Stock in trade	19,000
		Sundry debtors	1,000
		Machinery	2,00,000
	<u>2,99,000</u>		<u>2,99,000</u>

Ascertainment of Closing Capital (as on 31.3.2007)

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	3,000	Cash in hand	3,000
Capital (balancing figure)	3,28,000	Cash at Bank	37,000
		Stock in trade	29,000
		Sundry debtors	2,000
		Machinery	<u>2,60,000</u>
	<u>3,31,000</u>		<u>3,31,000</u>

Statement of Profit and Loss of Ramesh for the year ended 31.3.2007

	Rs.
Closing Capital	3,28,000
Add: Drawings during the year (Rs. 700 x 12)	8,400
	<u>3,36,400</u>
Less: Opening Capitals (as above)	2,94,000
Net profit for the year	<u>42,400</u>

- Note :*
1. The above profit of Rs. 42,400 earned by Ramesh is subject to depreciation on machinery.
 2. Opening balance + Deposit – Withdrawals = Rs. 77,000 + 2,30,000 – 2,70,000 = Rs. 37,000

Illustration 3

X and Y carried on business in partnership sharing profits in the ratio of 2:1. They had the following credit balances in the capital account on 31st March, 2006:

X	Rs. 3,45,000
Y	Rs. 1,80,000

A statement of affair's prepared on 31st March, 2007 discloses the following position:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Creditors for:		Cash in hand	67,500
Goods	1,95,000	Bank	45,000
Expenses	39,000	Debtors	2,55,000
		Stock	3,30,000
		Furniture	<u>42,000</u>
	<u>2,34,000</u>		<u>7,39,500</u>

During the year X had drawn Rs. 99,000 from the firm. He had also taken for personal use goods worth Rs. 12,000. He sold some goods of the business for Rs. 27,000 and retained their proceeds himself. He had personally paid to some of the employees of the firm Rs. 49,500 towards the salaries which he was entitled to be reimbursed. Y had withdrawn Rs. 37,500 in cash and had also taken for his personal use goods worth Rs. 7,500. He had paid towards some expenses of the firm Rs. 24,000 from his private estate.

Prepare a statement showing the profit of the firm for the year ended 31st March, 2007.

<i>Solution:</i>	<i>Rs.</i>
Total Assets on 31st March, 2007	7,39,500
Less: Liabilities on 31st March, 2007	<u>2,34,000</u>
Net Assets representing capitals of X and Y	<u>5,05,500</u>

Statement of Profit

	<i>Rs.</i>
Combined capitals of X and Y on 31st March, 2007	5,05,500
<i>Add : Drawings of X:</i>	
Cash	99,000
Goods	12,000
Sale proceeds of goods retained	<u>27,000</u>
<i>Drawings of Y</i>	
Cash	37,500
Goods	<u>7,500</u>
	<u>6,88,500</u>
<i>Less : Capital introduced in the form of:</i>	
Salaries to employees by X	(49,500)
Expenses of the firm paid by Y	<u>(24,000)</u>
Adjusted capitals of X and Y on 31st March, 2007	6,15,000

Less: Opening capitals of X and Y	<u>5,25,000</u>
Net profit for the year	<u>90,000</u>
X will get: $\frac{2}{3}$ of 90,000 = Rs. 60,000	
Y will get: $\frac{1}{3}$ of 90,000 = Rs. 30,000	

9. ASCERTAINMENT OF PROFIT BY CONVERSION METHOD

The net worth does not provide information regarding sales, purchases, gross profit, operating expenses etc. of the business. As a result, a meaningful analysis of the financial statements cannot be done. Therefore, it will be better to collect such information from the books of account and other sources which are necessary for preparing trial balance. This is done by preparing total debtors account, total creditors account, bills receivable account, bills payable account, receipt and payments account etc. on the basis of double entry. Accounts relating to different expenses, incomes, fixed assets and fixed liabilities and outstanding are also prepared with the help of receipts and payment account and additional information available. Thus, the closing balances of different accounts are found out and a trial balance is prepared from which profit and loss account is prepared.

If it is desired that books maintained on single entry system be converted into books on the double entry system, the following steps will have to be taken:

- (i) All the accounts appearing in the Statement of Affairs as in the beginning of the year should appear in ledger. Accounts which are not already there in the ledger should be opened with opening balances as appearing in the Statement of Affairs. Cash Account in the form of Cash Book and the accounts of trade debtors and trade creditors would already be there. Other personal accounts and all real accounts will have to be opened.
- (ii) The items which have not already been posted from the Cash Book will have to be posted to the relevant accounts. It will mean that all the nominal accounts will also be opened.
- (iii) The accounts of all the customers and suppliers will be analysed and double aspect of all those transaction will be completed whose double aspect has not already been completed. It will be mean that Sales Account, Purchases Account, Sales Returns Account, Purchases Returns Account, Bad Debts Account, Discount Account etc., will also be opened in ledger.
- (iv) Transactions which have not been recorded so far will now be recorded. For example entries will have to be made for outstanding expenses, depreciation of assets, income received in advance, etc.
- (v) Trial balance will be prepared. If it does not agree, errors will be located and rectified till the trial balance agrees.
- (vi) Final accounts and balance sheet will be prepared.

10. PREPARATION OF FINAL ACCOUNTS UNDER SINGLE ENTRY SYSTEM

It is not possible to prepare final accounts only on the basis of information contained in the books of accounts maintained under single entry system. But if some additional information required for the purpose is also made available, final accounts and balance sheet can be prepared without converting the books of account maintained under single entry system into books of account under double entry system. The work of preparation of final accounts in this way is referred to as abridged conversion. The process is described below:

Statement of affairs as at the beginning of the year is referred to in order to find out various assets and liabilities as at that date. The amount of stock in trade at that date is noted to be shown on the debit side of Trading Account.

A summary of Cash Book is prepared. Cash sales and cash purchases are ascertained from

Cash Book. In order to ascertain credit sales and credit purchases Total Debtors Account and Total Creditors Account are prepared. Opening Balances of trade debtors and trade creditors are ascertained from Statement of Affairs as at the end of the year. Cash received from debtors is ascertained from debit side of Cash Book whereas cash paid to creditors is ascertained from the credit side of the Cash Book. Balancing figures are credit sales and credit purchases. Suppose, on 1st January, 2007 debtors amounted to Rs. 12,500 and on 31st December, 2007 they totalled Rs. 15,700. If cash received from debtors during the year amount to Rs. 1,06,530, credit sales come to Rs. 1,09,730 as calculated below:

<i>Dr.</i>	Total Debtors Account		<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
To Balance b/d	12,500	By Cash	1,06,530
To Credit Sales	1,09,730	By Balance c/d	15,700
(Balancing figure)			
	<u>1,22,230</u>		<u>1,22,230</u>
To Balance b/d	<u>15,700</u>		

Other items like bills receivable received from debtors during the year, discount allowed to debtors and bad debts written off may also have to be shown in Total Debtors Account.

The amount of bills receivable received from debtors during a year may, also have to be calculated by preparing a Bills Receivable Account.

Example 4:

	<i>Rs.</i>
Bills Receivable on 1.4.2006	17,000
Cash received on maturity of bills	95,000
Bills Receivable on 31.3.2007	10,000

Answer

<i>Dr.</i>	Bills Receivable Account		<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
To Balance b/d	17,000	By Cash	95,000
To Trade Debtors	88,000	By Balance b/d	10,000
(Balancing figure, being the amount of bills received during the year)			
	<u>1,05,000</u>		<u>1,05,000</u>
To Balance b/d	<u>10,000</u>		

The balancing figure of Rs. 88,000 is the amount of Bills Receivable received during the year. The amount of Rs. 88,000 will appear on the credit side of Total Debtors Account as By Bills Receivable Account Rs. 88,000.

Similarly, the amount of Bills Payable issued during the year can be calculated by preparing a Bills Payable Account.

Example

	<i>Rs.</i>
Bills Payable on 1.4.2006	25,000
Cash paid on Bills Payable	80,000
Bills Payable on 31.3.2007	35,000

Answer :

Dr.	Bills Payable Account		Cr.
	Rs.		Rs.
To Cash	80,000	By Balance b/d	25,000
To Balance c/d	35,000	By Trade Creditors	90,000
		(Balancing figure)	
	<u>1,15,000</u>		<u>1,15,000</u>
To Balance b/d	35,000		

The amount of Rs. 90,000 (balancing figure), i.e., Bills Payable issued during the year, will appear in the debit side of total creditor's account as:

To Bills Payable (issued during the year) Rs. 90,000

Thus, by first preparing Bills Receivable Account or Bills Payable Account (if necessary) and then preparing Total Debtor's Account or Total Creditors Account, we can ascertain credit sales or credit purchase if not given in the question.

Illustration 4 :

The following balances extracted from the Books of Mr. Prasad.

	Rs.
Debtors on 1.4.2006	12,500
Creditors on 1.4.2006	48,000
Cash received from Debtors	1,06,530
Discount allowed to Debtors	1,000
Cash paid to Creditors	80,000
Discount received	1,500
Bills payable issued during the year	90,000
Bills receivable received during the year	88,000
Bad debts	500
Balance on 31.3.2007:	
Debtors	15,700
Creditors	50,000
Cash Sales	50,000
Cash Purchases	20,000

Find out the total sales and total purchases.

Solution:

Dr.	Total Debtors Account		Cr.
	Rs.		Rs.
To Balance b/d	12,500	By Cash	1,06,530
To Sales	1,99,230	By Discount	1,000
(Balancing figure)		By Bills Receivable	88,000
		(Received during the year)	
		By Bad Debts	500
		By Balance b/d	15,700
	<u>2,11,730</u>		<u>2,11,730</u>

Total Creditors Account

	Rs.		Rs.
To Cash	80,000	By Balance b/d	48,000
To Discount	1,500	By Purchases	1,73,500
To B/P (issued during the year)	90,000	(Balancing figure)	
To Balance c/d	<u>50,000</u>		
	2,21,500		<u>2,21,500</u>

	Rs.
Thus the credit sales (balancing figure)	1,99,230
Cash Sales	50,000
Total Sales	<u>2,49,230</u>
Similarly credit purchases (Balancing figure)	1,73,500
Cash purchases	20,000
Total Purchases	<u>1,93,500</u>

Cash sales plus credit sales are shown on the credit side of Trading Account and cash purchases plus credit purchases are shown on the debit side of the Trading Account. Closing stock to be shown on the credit side of the Trading Account is ascertained from Statement of Affairs as at the end of the year. Wages, carriage inwards and other expenses to be shown on the debit side of Trading Account are ascertained from credit side of Cash Book. Of course, adjustments have to be made for prepaid and outstanding expenses. All this enables the accountant to prepare Trading Account. The gross profit or gross loss revealed by Trading Account is transferred to Profit and Loss Account.

Most of the items to be shown in the Profit and Loss Account are found in the Cash Book. Expenses to be shown on the debit side of Profit and Loss Account are ascertained from credit side of Cash Book and incomes to be shown on the credit side of the Profit and Loss Account are to be ascertained from the debit side of the Cash book. Of course adjustments to amounts appearing in Cash Book may have to be made for prepaid and outstanding amounts. Also information regarding some items like depreciation on fixed assets, interest on capital, etc., will not be available in Cash Book and will have to be obtained from other sources. Net profit or net loss revealed by Profit and Loss Account is transferred to capital account.

An analysis of Cash Book will also reveal additions to assets and sales, thereof. For example, if more furniture has been purchased during the year, an entry will be found on the credit side of Cash Book, say, "By Furniture.....Rs. 25,000". Similarly if some asset has been sold during the year, the sale proceeds will be found on record on debit side of Cash Book, say, "To Machinery....Rs. 2,00,000". In case of sale, book value of the asset sold must be ascertained and any profit or loss on sale of the asset should be shown on the appropriate side of the Profit and Loss Account. From the asset account concerned book value of the asset sold will be deducted. Record of drawings made by the proprietor will also be available on the credit side of Cash Book. Similarly, if the proprietor has introduced additional capital during the year, information about the same will be available from the debit side of Cash Book. Some other information may be made available by the proprietor himself. Balance Sheet is prepared on the basis of information gathered in this way.

It must have become clear that the Cash Book plays a very significant role in this process. In the examination if a regular Cash Book is not given, the student should prepare one to ascertain that no items have been left out. Usually in the examination, missing items have to be found in a question on single entry system. If the Cash Book does not agree, a shortage on the debit side

may mean opening balance of cash or bank, closing bank overdraft, cash sale or addition of capital brought in by the proprietor in that order and a shortage on the credit side may mean closing balance of cash or bank or opening bank overdraft, cash purchases or drawings in that order.

Besides the need to find a missing item in the Cash Book, the question may also make it necessary to calculate closing debtors, closing stock etc. Students are, therefore, advised to study the question on single entry system very carefully to locate missing items.

Illustration 5 :

The books of Shri Khurana showed the following figures:

	<i>April 1, 2006</i> <i>Rs.</i>	<i>March 31, 2007</i> <i>Rs.</i>
Cash at bank	35,000	85,000
Cash in hand	4,100	8,500
Stock-in-trade	2,25,000	2,55,000
Sundry Debtors	1,80,000	?
Sundry Creditors	80,000	73,000
Bills Payable	2,00,000	1,80,000
Furniture and Fittings	50,000	?
Outstanding Salary	2,000	?

The Cash Book analysis showed the following figures amongst others:

	<i>Rs.</i>		<i>Rs.</i>
Receipts from customers	10,50,000	Drawings	60,000
Discounts allowed to them	13,000	Payment to creditors	1,90,000
Salaries upto 31st March, 2007	26,000	Discount received	
Rent	36,000	from them	26,000
Sundry trade expenses	85,000	Payment for Bills	
Furniture purchased		payable	8,00,000
on 1.10.2006	10,000		

Depreciation is provided on Furniture and Fittings @ 10% per annum. No ready figures are available for total sales. However, Khurana informs you that he maintains a steady gross profit rate of 25% on sales.

Prepare Khurana's Trading and Profit and Loss Account for the year ended 31st March, 2007 and the Balance Sheet as at date.

Solution:

Cash Book			
<i>Dr.</i>			<i>Cr.</i>
To Balance b/d		By Salaries	26,000
Cash at bank	35,000		

Cash in hand	<u>4,100</u>	39,100	By Rent		36,000
To Sundry Debtors		10,50,000	By Sundry trade expenses		85,000
To Cash Sales		2,11,400	By Drawings		60,000
(Balancing figure)			By Furniture		10,000
			By Sundry creditors		1,90,000
			By Bills payable		8,00,000
			By Balance c/d		
			Cash at bank	85,000	
			Cash in hand	<u>8,500</u>	<u>93,500</u>
		<u>13,00,500</u>			<u>13,00,500</u>

Bills Payable Account

	<i>Rs.</i>		<i>Rs.</i>
To Cash	8,00,000	By Balance b/d	2,00,000
To Balance b/d	1,80,000	By Sundry creditors	
		(Balancing figures)	<u>7,80,000</u>
	<u>9,80,000</u>		<u>9,80,000</u>

Sundry Creditors Account

	<i>Rs.</i>		<i>Rs.</i>
To Cash	1,90,000	By Balance b/d	80,000
To Discount	26,000	By Credit purchases	9,89,000
To Bills Payable	7,80,000	(Balancing figure)	
To Balance c/d	<u>73,000</u>		
	<u>10,69,000</u>		<u>10,69,000</u>

Calculation of Credit Sales:

	<i>Rs.</i>
Opening stock	2,25,000
Add: Purchases (as per total creditors account)	<u>9,89,000</u>
	12,14,000
Less: Closing stock	<u>2,55,000</u>
Cost of Sales	<u>9,59,000</u>

Total Sales $9,59,000 \times \frac{100}{75} =$ Rs. 12,78,667 (approx.)

Cash Sales (as per cash book) 2,11,400

Credit Sales Rs. 12, 78,667 — Rs. 2,11,400
= Rs. 10,67,267

Total Debtors Account

<i>Dr.</i>	<i>Cr.</i>
<i>Rs.</i>	<i>Rs.</i>

To Balance b/d	1,80,000	By Cash	10,50,000
To Credit Sales	10,67,267	By Discount	13,000
	<u> </u>	By Balance c/d (bal. figure)	<u>1,84,267</u>
	12,47,267		12,47,267
	<u> </u>		<u> </u>

Statement of Affairs as on 1st April, 2006

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Creditors	80,000	Cash at bank	35,000
Bills payable	2,00,000	Cash in hand	4,100
Outstanding salary	2,000	Sundry debtors	1,80,000
Capital (Excess of assets		Stock in trade	2,25,000
over liabilities-Balancing figure)	<u>2,12,100</u>	Furniture and fittings	<u>50,000</u>
	4,94,100		4,94,100
	<u> </u>		<u> </u>

**Trading and Profit and Loss Account of Khurana
for the year ended on 31st March, 2007**

<i>Dr.</i>			<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
To Opening Stock	2,25,000	By Sales	12,78,667
To Purchases	9,89,000	By Closing stock	2,55,000
To Gross Profit c/d	<u>3,19,667</u>		
	15,33,667		<u>15,33,667</u>
To Discount Allowed	13,000	By Gross Profit b/d	3,19,667
To Salaries	26,000	By Discount Received	26,000
Less: o/s for last year	<u>2,000</u>		
To Rent	36,000		
	<i>Rs.</i>		<i>Rs.</i>
To Sundry Trade Expenses	85,000		
To Depreciation on furniture:			
on Rs. 50,000 for 1 year	5,000		
on Rs. 10,000 for 6 months	<u>500</u>		
To Net profit transferred to Capital Account	<u>1,82,167</u>		
	3,45,667		<u>3,45,667</u>
	<u> </u>		<u> </u>

Balance Sheet of Khurana as on 31st March, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Bills Payable	1,80,000	Cash in Hand	8,500

Sundry Creditors	73,000	Cash at Bank	85,000
Capital :		Sundry Debtors	1,84,267
As per Statement of		Stock in Trade	2,55,000
Affairs on 1.4.2006	2,12,100	Furniture	50,000
Less: Drawings	<u>60,000</u>	Add: Furniture	
	1,52,100	bought on 1.10.2006	<u>10,000</u>
Add: Net Profit	<u>1,82,167</u>		60,000
	3,34,267	Less: Depreciation	<u>5,500</u>
	<u>5,87,267</u>		<u>54,500</u>
			<u>5,87,267</u>

Illustration 6 :

Shri Ramdas commenced business on 1 April, 2006 with a capital of Rs. 90,000. He immediately purchased furniture of Rs. 48,000. During the year he received from his uncle a gift of Rs. 6,000 and he borrowed from his father a sum of Rs. 10,000. He had withdrawn Rs. 1,200 per month for his household expenses. He had no bank account and all dealings were in cash. He did not maintain any books but following information is given:

	Rs.
Sales (including cash sales of Rs. 60,000)	2,00,000
Purchases (including cash purchases of Rs. 20,000)	1,50,000
Carriage inwards	1,400
Wages	600
Discount allowed to debtors	2,400
Salaries	12,400
	Rs.
Bad debts written off	2,200
Trade expenses	2,400
Advertisements	4,400

He used goods worth Rs. 2,600 for his personal use and paid Rs. 1,000 to his son for examination and college fees.

On 31st March, 2007, his debtors were worth Rs. 42,000 and creditors Rs. 30,000. Stock in trade was valued at Rs. 20,000. Furniture to be depreciated by 10 % p.a.

Prepare Trading and Profit and Loss Account for the year ended on 31st March, 2007.

Solution :

Total Debtors Account

<i>Dr.</i>			<i>Cr.</i>
	Rs.		Rs.
To Sales (Credit)	1,40,000	By Cash (Balancing figure)	93,400
(2,00,000 – 60,000)		By Bad Debts	2,200
		By Discount allowed	2,400
		By Balance c/d	<u>42,000</u>
	<u>1,40,000</u>		<u>1,40,000</u>

Total Creditors Account

	Rs.		Rs.
To Cash (balancing figure)	1,00,000	By Purchases (Credit)	
To Balance c/d	<u>30,000</u>	(1,50,000 – 20,000)	<u>1,30,000</u>

1,30,000

1,30,000

Cash Book (Cash Column only)

	<i>Rs.</i>		<i>Rs.</i>
To Capital Account	90,000	By Furniture Account	48,000
To Loan (from Father)	10,000	By Drawings (1,200 x 12)	14,400
To Capital Account (gift)	6,000	By Purchases	20,000
To Sales	60,000	By Carriage inwards	1,400
To Debtors	93,400	By Wages	600
		By Salaries	12,400
		By Trade expenses	2,400
		By Advertisements	4,400
		By Drawings (Son's fees)	1,000
		By Creditors	1,00,000
		By Balance c/d	
		(Balancing figure)	<u>54,800</u>
	<u>2,59,400</u>		<u>2,59,400</u>

**Trading and Profit and Loss Account
for the year ending 31.3.2007**

	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>
To Purchases	1,50,000		By Sales	2,00,000
Less : Drawings	<u>2,600</u>	1,47,400	By Stock at the end	20,000
To Carriage inwards	1,400			
To Wages	600			
To Profit and Loss Account (Gross Profit)	70,600			
	<u>2,20,000</u>			<u>2,20,000</u>
To Salaries	12,400		By (Gross Profit)	70,600
To Discount allowed	2,400			
To Bad Debts	2,200			
To Advertisements	4,400			
To Trade expenses	2,400			
To Depreciation on furniture (10% on Rs. 48,000)	4,800			
To Net Profit transferred to Capital Account	<u>42,000</u>			
	<u>70,600</u>			<u>70,600</u>

**Shri Ramdas
Balance Sheet as at 31st March, 2007**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital		Cash in Hand	54,800
Balance on 1.4.2006	90,000	Debtors	42,000
Add : Gift	6,000	Furniture	48,000

Net Profit	<u>42,000</u>	Less: Depreciation	<u>4,800</u>	43,200
	1,38,000	Stock at the end		20,000
<i>Less : (Drawings)</i>				
Household expenses	14,400			
Son's fees	1,000			
Goods withdrawn for personal use	<u>2,600</u>	1,20,000		
Creditors		30,000		
Father's Loan	<u>10,000</u>			
	1,60,000			<u>1,60,000</u>

Illustration 7 :

Shri A.K. Makheeja returned to India from London after retirement and purchased a small retail business. He took over the business on 1st April, 2006 acquiring the existing stock at a valuation of Rs. 22,840 and the rest of the purchase consideration was apportioned as to Rs. 30,000 for fixtures and fittings and the balance for goodwill.

He used his existing bank account and, other than bank statements and vouchers, the only record available was a till book recording cash payments from the till. Surplus cash was banked periodically during the year.

A summary of this bank account for the year ended 31st March, 2007 shows:

	Rs.		Rs.
Balance 1 April, 2006	72,920	Purchases of business	63,840
Pension from employment	19,500	Rent 15 months to 30th June, 2007	10,000
Bankings from shop	3,28,540	Rates 9 months to 31st Dec., 2006	1,680
		Electricity	1,840
		Hire of frozen food cabinet	1,600
		Purchases for resale	2,94,000
		Private cheques	22,440
		Balance 31 March, 2007	<u>25,560</u>
	<u>4,20,960</u>		<u>4,20,960</u>

A summary of the till book for the year ended 31st March, 2007 shows:

	Rs.
Cash purchases for resale	32,120
Staff salaries	14,840
Sundry shop expenses	3,120
Cash drawings	10,400

On 31st March, 2007 stock valued at cost amounted to Rs. 30,840, amounts due from customers Rs. 1,480, and cash in hand amounted to Rs. 1,080. Depreciation is to be provided on

fixtures and fittings at a rate of 10%.

Accounts outstanding on 31st March, 2007 were: purchases Rs. 9,400 and rates for the year ending 31st December, 2007 Rs. 2,400.

You are required to prepare Trading and Profit and Loss Account for the year ended 31st March, 2007 and a balance sheet as on that date.

Solution :

Capital Account			
<i>Dr.</i>			<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
To Balance b/d	92,420	By Bank	72,920
		By Pension	<u>19,500</u>
	<u>92,420</u>		<u>92,420</u>
		By Balance b/d	92,420

Total Debtors Account			
<i>Dr.</i>			<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
Credit Sales		By Bank	3,28,540
(Balancing figure)	<u>3,30,020</u>	By Balance b/d	<u>1,480</u>
	<u>3,30,020</u>		<u>3,30,020</u>
To Balance b/d	1,480		

Total Creditors Account			
	<i>Rs.</i>		<i>Rs.</i>
To Bank	2,94,000	By Credit Purchases	
To Balance c/d	<u>9,400</u>	(Balancing figure)	<u>3,03,400</u>
	<u>3,03,400</u>		<u>3,03,400</u>
		By Balance b/d	9,400

Drawings Account			
	<i>Rs.</i>		<i>Rs.</i>
To Bank	22,440	By Balance c/d	32,840
To Cash	<u>10,400</u>		
	<u>32,840</u>		<u>32,840</u>
To Balance b/d	32,840		

Cash Account			
	<i>Rs.</i>		<i>Rs.</i>
To Cash Sales		By Purchases	32,120
(Balancing figure)	61,560	By Staff wages	14,840
		By Sundry shop expenses	3,120
		By Drawings	10,400
		By Balance c/d	<u>1,080</u>
	<u>61,560</u>		<u>61,560</u>
To Balance b/d	1,080		

Total Sales = Rs. 3,30,020 + Rs. 61,560 = Rs. 3,91,580

Total Purchases = Rs. 3,03,400 + Rs. 32,120 = Rs. 3,35,520

**Trading and Profit and Loss Account
for the year ending 31st March, 2007**

	Rs.		Rs.
To Opening Stock	22,840	By Sales	3,91,580
To Purchases	3,35,520	By Closing Stock	30,840
To Gross Profit	<u>64,060</u>		
	4,22,420		<u>4,22,420</u>
To Salaries	14,840	By Gross Profit	64,060
To Rates	1,680		
Add: Outstanding	<u>600</u>		
	2,280		
To Rent 10,000 x 12/15	8,000		
To Electricity	1,840		
To Hire of frozen food cabinet	1,600		
To Sundry expenses	3,120		
To Depreciation on fixtures and fittings	3,000		
To Net Profit transferred to Capital Account	<u>29,380</u>		
	64,060		<u>64,060</u>

**Shri A.K. Makheeja
Balance Sheet as at 31st March, 2007**

Liabilities	Rs.	Assets	Rs.
Capital	72,920	Fixed Assets:	
Add: Pension	19,500	Goodwill	11,000
Profit	<u>29,380</u>	Fixtures and Fittings	
	1,21,800	(30,000 – 3,000)	27,000
Less: Drawings	<u>32,840</u>	Current Assets:	
	88,960	Stock	30,840
Current Liabilities:		Debtors	1,480
Creditors for Purchases	9,400	Cash at Bank	25,560
Outstanding Rates	600	Cash in hand	1,080
		Rent prepaid	<u>2,000</u>
	<u>98,960</u>		<u>98,960</u>

Illustration 8 :

The following facts have been ascertained from the records of Mathew who maintains his books of accounts under the single entry system:

Rs.

Receipts for the year ended 31st March, 2007:

From sundry debtors	1,76,250
Cash sales	41,250
Paid in by Mathew, the proprietor	25,000
	2,42,500

Payments made during the year ended 31st March, 2007:

	<i>Rs.</i>
New furniture purchased	6,250
Drawings	15,000
Wages	67,250
Salaries	11,250
Interest paid	750
Telephone	1,250
Rent	12,000
Light and power	4,750
Sundry expenses	21,250
Sundry creditors	76,250
	2,16,000

It may be noted that Mathew banks all receipts and makes all payments only by means of cheques.

Assets and Liabilities:

	<i>As at 1st April, 2006</i>	<i>As at 31st March, 2007</i>
	<i>Rs.</i>	<i>Rs.</i>
Sundry creditors	25,250	24,000
Sundry debtors	37,500	61,250
Bank	6,250	?
Stock	62,500	31,250
Furniture	75,000	73,150

From the above data, prepare the trading and profit and loss account for the year ended 31st March, 2007 and balance sheet as on that date.

Solution:

Trading and Profit and Loss Account of Shri Mathew for the year ended 31st March, 2007			
<i>Dr.</i>			<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
To Opening Stock	62,500	By Sales:	
To Purchases	75,000	Cash	41,250
To Wages	67,250	Credit	<u>2,00,000</u>
To Light and power (taken as direct expenditure)	4,750	By Closing stock	31,250

To Gross Profit c/d	<u>63,000</u>				<u>2,72,500</u>				<u>2,72,500</u>
To Salaries	11,250	By Gross Profit b/d							63,000
To Interest	750								
To Telephone	1,250								
To Rent	12,000								
To Sundry expenses	21,250								
To Depreciation on furniture	8,100								
To Net profit transferred to Capital A/c	<u>8,400</u>								
	<u>63,000</u>								<u>63,000</u>

**Balance Sheet of Shri Mathew
as on 31st March, 2007**

	Rs.		Rs.
Sundry creditors	24,000	Cash at bank	32,750
Capital	1,56,000	Sundry debtors	61,250
Add: Profit	8,400	Closing stock	31,250
Capital introduced	<u>25,000</u>	Furniture	75,000
	1,89,400	Add: Addition	<u>6,250</u>
Less : Drawings	<u>15,000</u>		81,250
	1,74,400	Less: Depreciation	<u>8,100</u>
	<u>1,98,400</u>		<u>73,150</u>
			<u>1,98,400</u>

Working Notes:

1. Calculation of Credit Purchases:

Dr.	Sundry Creditors A/c		Cr.
	Rs.		Rs.
To Bank A/c	76,250	By Balance b/d	25,250
To Balance c/d	24,000	By Credit Purchases	75,000
		(balancing figure)	
	<u>1,00,250</u>		<u>1,00,250</u>
		By Balance b/d	24,000

2. Calculation of Credit Sales:

Sundry Debtors A/c

	Rs.		Rs.
To Balance b/d	37,500	By Bank A/c	1,76,250
To Credit Sales	2,00,000	By Balance b/d	61,250
(Balancing figure)	<u>2,37,500</u>		<u>2,37,500</u>
To Balance b/d	61,250		

3. Calculation of Depreciation:

	Rs.
Furniture as on 01.04.2006	75,000
Add: Furniture purchased during the year	<u>6,250</u>

	81,250
Less: Furniture as on 31.3.2007	<u>73,150</u>
Depreciation for the year	<u>8,100</u>

4. Calculation of Cash Balances:

Bank A/c			
	Rs.		Rs.
To Balance b/d	6,250	By Purchases of furniture	6,250
To Sundry debtors	1,76,250	By Drawings	15,000
To Cash Sales	41,250	By Wages	67,250
To Capital A/c	25,000	By Salaries	11,250
(Additional capital introduced)		By Interest	750
		By Telephone	1,250
		By Rent	12,000
		By Light and power	4,750
		By Sundry expenses	21,250
		By Sundry creditors	76,250
		By Balance c/d	<u>32,750</u>
	<u>2,48,750</u>		<u>2,48,750</u>

5. Calculation of Capital as on 01.04.2006:

Statement of Affairs as on 01.04.2006			
	Rs.		Rs.
Sundry creditors	25,250	Cash at bank	6,250
Capital	1,56,000	Stock	62,500
(balancing figure)		Sundry debtors	37,500
		Plant	<u>75,000</u>
	<u>1,81,250</u>		<u>1,81,250</u>

Illustration 9 :

Bose has supplied the following information about his business to you:

Assets and Liabilities	On 1st April 2006 (Rs.)	On 31st March, 2007 (Rs.)
Sundry debtors	1,81,000	1,93,000
Stock	1,50,000	1,40,000
Machinery	2,50,000	?
Furniture	40,000	?
Sundry creditors	1,10,000	1,25,000

Summary of cash book for the year ended 31st March, 2007 is as follows:

Receipts	Rs.	Payments	Rs.
To Opening balance	5,000	By Payments to creditors	3,50,000
To Cash sales	61,000	By Wages	1,60,000
To Receipt from debtors	7,53,000	By Salaries	1,50,000
To Misc. receipts	2,000	By Drawings	40,000
To Loan from Dass		By Sundry office expenses	1,10,000
@ 9% per annum		By Machinery purchased	

(taken on 1.10.2006)	1,00,000	(on 1.10.2006)	95,000
		By Closing balance balance	<u>16,000</u>
	<u>9,21,000</u>		<u>9,21,000</u>

Discount allowed totalled Rs.7,000 and discount received was Rs.4,000. Bad debts written off were Rs.8,000. Depreciation was written off on furniture @5% per annum and machinery @10% per annum under the straight line method of depreciation. The office expenses included Rs.5,000 paid as insurance premium for the year ending 30th June, 2007. Wages amounting to Rs.20, 000 were still due on 31st March, 2007.

Prepare trading and profit and loss account for the year ended 31st March, 2007 and the balance sheet as on that date.

Solution:

Total Debtors A/c

Dr.		Cr.	
Particulars	Rs.	Particulars	Rs.
To Balance b/d	1,81,000	By Cash	7,53,000
To Credit Sales		By Discount	7,000
(balancing figure)	7,80,000	By Bad Debts	8,000
		By Balance c/d	1,93,000
	<u>9,61,000</u>		<u>9,61,000</u>

Total Creditors A/c

Particulars	Rs.	Particulars	Rs.
To Cash	3,50,000	By Balance b/d	1,10,000
To Discount	4,000	By Purchases	
To Balance c/d	<u>1,25,000</u>	(balancing figure)	<u>3,69,000</u>
	<u>4,79,000</u>		<u>4,79,000</u>

Statement of Affairs as on 1st April, 2006

Particulars	Rs.	Particulars	Rs.
Creditors	1,10,000	Cash	5,000
Capital	5,16,000	Stock	1,50,000
(balancing fig.)		Debtors	1,81,000
		Furniture	40,000
		Machinery	<u>2,50,000</u>
	<u>6,26,000</u>		<u>6,26,000</u>

Dr.	Trading Account for the year ending 31st March, 2007				Cr.
Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening Stock	1,50,000		By Sales:		
To Purchases	3,69,000		Cash	61,000	
To Wages	1,60,000		Credit	<u>7,80,000</u>	8,41,000
Add: Wages			By Closing Stock		1,40,000
Outstanding	<u>20,000</u>	1,80,000			
To Gross Profit c/d		<u>2,82,000</u>			
		<u>9,81,000</u>			<u>9,81,000</u>

Profit and Loss Account for the year ending 31st March, 2007

<i>Particulars</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Particulars</i>	<i>Rs.</i>
To Salaries		1,50,000	By Gross profit b/d	2,82,000
To Sundry Office Expenses	1,10,000		By Miscellaneous receipts	2,000
Less: Unexpired Insurance	<u>1,250</u>	1,08,750	By Discount received	4,000
To Interest on (for 6 months @9% on Rs.1,00,000)		4,500	By Net Loss Transferred to Capital Account	22,000
To Discount allowed		7,000		
To Bad Debts		8,000		
To Depreciation on: Machinery	29,750			
Furniture	<u>2,000</u>	<u>31,750</u>		
		<u>3,10,000</u>		<u>3,10,000</u>

Balance Sheet as on 31st March, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>
Sundry Creditors		1,25,000	Machinery	2,50,000	
Wages Outstanding		20,000	Add: Additions	<u>95,000</u>	
Loan Account	1,00,000			3,45,000	
Add: Interest due	<u>4,500</u>	1,04,500	Less: Depreciation	<u>29,750</u>	3,15,250
Capital:					
Opening Balance	5,16,000		Furniture	40,000	
Less: Net Loss	<u>22,000</u>		Less: Depreciation	<u>2,000</u>	38,000
	4,94,000		Stock		1,40,000
Less: Drawings	<u>40,000</u>	4,54,000	Debtors		1,93,000
			Cash		16,000
			Unexpired Insurance		<u>1,250</u>
		<u>7,03,500</u>			<u>7,03,500</u>

SELF-TEST QUESTIONS

1. What is single entry system? How does it differ from double entry system?
2. What are the defects of single entry system? Are there any advantages also? In what type of concerns is it suitable?
3. What is a statement of affairs? How does it differ from balance sheet?
4. Bhola maintains his books of accounts on single entry system. His capital as per statement of affairs on 1st January, 2007 was Rs. 1,47,900 but statement of affairs on 31st December, 2007 showed it as Rs. 1,50,800. He requests you to find out the profit he has earned in 2007. On enquiry he tells you that he introduced Rs. 20,000 by way of additional capital on 1st March, 2007 and that his drawings for the whole year amounted to Rs. 51,000.
What is his profit? (Ans.: Rs. 33,900)
5. At the end of an accounting year, a trader who has maintained his books of account on single entry system requests you to convert his books of account on single entry system into double entry system. What steps will you have to take to do so?
6. How do you prepare final accounts under single entry system ?
7. Find out total purchases for 2007 on the basis of the following particulars:

- | | |
|--|----------------------|
| | Rs. |
| Total Trade Creditors as on 1.1.2007 | 37,000 |
| Total Bills Payable as on 1.1.2007 | 22,000 |
| Total Trade Creditors as on 31.12.2007 | 39,560 |
| Total Bills Payable as on 31.12.2007 | 18,000 |
| Cash paid for bills payable during the year | 80,000 |
| Discount received from creditors during the year | 1,370 |
| Cash paid to trade creditors during the year | 39,950 |
| Cash purchases made during the year | 32,540 |
| | (Ans.: Rs. 1,52,420) |
8. Find out the total amount payable by trade debtors as on 31st December, 2005 on the basis of the following data:
- | | |
|--|-----------------|
| | Rs. |
| Amount payable by trade debtors as on 1.1.2007 | 41,200 |
| Balance on Bills Receivable Account as on 1.1.2007 | 20,000 |
| Credit Sales for 2007 | 1,91,260 |
| Cash received from trade debtors during 2007 | 1,30,620 |
| Discount allowed to trade debtors during 2007 | 7,360 |
| Cash received for bills receivable during 2007 | 50,000 |
| Balance of Bills Receivable Account as on 31.12.2007 | 8,000 |
| | (Ans. : 56,480) |
9. From the following data, prepare Trading Account for the year ended 31st December, 2007
- | | |
|----------------------|----------|
| | Rs. |
| Stock as on 1.1.2007 | 31,730 |
| Cash sales | 1,30,216 |
| Credit sales | 77,784 |
| Total purchases | 1,61,634 |
- The firm sells goods at cost plus 30%.
Hint: Cost of goods sold, Rs. 1, 60,000, closing stock Rs. 33,364
- (Ans.: Gross Profit, Rs. 48,000)
10. In a question on single entry system, if incomplete Cash Book is given to you, what assumptions will you make?
11. Rama is a small cloth merchant, who has not kept full double entry records. His position as on 1st January, 2007 stood as follows:
Cash in hand Rs. 1,520; balance at bank Rs. 13,900; stock Rs. 25,200; sundry debtors Rs. 9,000; furniture Rs. 4,000 and sundry creditors Rs. 8,620.
His position on 31st December of 2007 is as follows:
Cash in hand Rs. 940; balance at bank as per bank pass book Rs. 11,860; stock Rs. 33,400; sundry debtors Rs. 12,640; furniture Rs. 4,000; scooter Rs. 8,000 and sundry creditors Rs. 10,600.
During the year he had withdrawn Rs. 800 per month for his personal expenses and purchased a scooter for his business use for Rs. 8,000. A cheque for Rs. 2,000 issued on 29.12.2007 was presented for payment on 12.1.2008.
Prepare a statement showing his trading results for the year ended 31st December, 2007 and a balance sheet as on 31st December, 2007 after (a) providing 10% depreciation on furniture and 20% depreciation on scooter; (b) writing off Rs. 640 as actual debts; and (c) making a 5% provision for likely bad debts.
Net profit: Rs.11,600
- (Ans.:)
12. Davis commenced business as a cloth merchant on 1st April, 2006 with a capital of Rs.

2,00,000. On the same day, he purchased furniture and fittings for cash Rs. 60,000. From the following particulars obtained from his books kept by single entry, you are asked to prepare a trading and profit and loss account for the year ending 31st March, 2007 and a balance sheet as on that date:

	Rs.
Sales (inclusive of cash Rs. 1, 40,000)	3,40,000
Purchases (inclusive of cash Rs. 80,000)	3,00,000
Davis's drawings	24,000
Salaries of staff	40,000
Bad debts written off	10,000
Business expenses	14,000

Davis took cloth worth Rs. 10,000 from the shop for private use and paid Rs. 4,000 to his son, but omitted to record these transactions in his books. On 31st March, 2007, his sundry debtors were Rs. 1,04,000 and sundry creditors Rs. 72,000. Stock in hand on 31st March, 2007 was Rs. 1,30,000.

Suggested Readings :

- (1) *R.L. Gupta and V.K. Gupta* — Financial Accounting
 - (2) *J.R. Monga* — Advanced Financial Accounting
 - (3) *M.C. Shukla, T.S. Grewal and S.C. Gupta* — Advanced Accounts - Vol. 1
 - (4) *S.P. Jain and K.L. Narang* — Financial Accounting
-

STUDY X

ACCOUNTING FOR CONSIGNMENTS AND JOINT VENTURES

1. ACCOUNTING FOR CONSIGNMENTS

1. MEANING OF CONSIGNMENT

Consignment is the process of sending of goods by one person to another person for the purpose of sale on commission basis at the sole risk of the sender. In other words, when goods are sent by one person to another to be sold by the latter on behalf and at the risk of the former, the transaction is known as consignment. The person who sends the goods to be sold on his behalf is called the 'consignor' whereas the person to whom the goods are sent to be sold is called 'consignee'. Consignment outward means that goods have been sent to some person on consignment basis while consignment inward implies that good shave been received to be sold on behalf of some other person on consignment basis. The goods consigned to the agent cannot be treated as sales at the time of consignment, they are treated as sales only when these goods are sold by the consignee.

The legal relationship between consignor and consignee is that of a principal and agent; consignor being the principal and consignee being the agent. Hence, when the consignor sends goods, the title to the goods does not pass from consignor to the consignee and the consignee does not become liable to pay for the goods so sent.

2. FEATURES OF CONSIGNMENT

On the basis of what has been stated above, the salient features of the consignment transaction may be summarised as follows:

- (i) Consignment of goods is not a sale. It is a mere transfer of possession of goods.
- (ii) The relationship between the consignor and consignee is that of principal and agent, not of seller and buyer, the goods never become the property of the consignee. The consignee is not responsible for any loss or destruction of goods.
- (iii) The consignee does not become the debtor of the consignor until he has sold the whole or portion of the consignment. When the goods have been sold he becomes liable for the payment of the proceeds.
- (iv) Bad debts in respect of goods consigned are borne by the consignor unless the consignee expressly assumes liability for such losses. In such case he is known as *del credere* agent and receives an extra rate of commission for the risk involved in credit sales effected by him.
- (v) The consignor has to pay all the expenses incurred by the consignee in taking the delivery of the goods when they reach the consignee's place and also the storage charges and other expenses until the goods are sold.
- (vi) The consignee is liable to account for the goods he receives from the consignor until they are sold.
- (vii) The consignee is paid by a commission which is generally based on the total value of sales affected by him.
- (viii) The unsold portion of the goods sent on consignment must appear in the assets side of the consignor's balance sheet as stock on consignment, because the unsold goods remain the property of the consignor until sold.
- (ix) Consignment transaction is distinguished from goods on sale or return. When goods are sent on consignment, the person receiving the goods is the agent of the sender, but in the case of goods sent on sale or return basis, the person to whom the goods are sent is only an optional purchaser.
- (x) Consignee is liable for payment on the sale proceeds after deducting, of course, his commission and the expenses incurred by him.
- (xi) It is customary for the consignee to give an advance to the consignor in the form of cash or bill of exchange. This advance is adjusted against the sale of goods.

3. DISTINCTION BETWEEN SALE AND CONSIGNMENT

	<i>Sale</i>	<i>Consignment</i>
(i)	In case of sale, property in goods is transferred to the buyer alongwith the transfer of goods.	In case of consignment, goods remain the property of the consignor until the time they are sold by consignee.
(ii)	Goods once sold can not be returned to the seller except when they are defective or the seller agrees to take these back.	Unsold goods on consignment are the property of the consignor and can be returned to him.

(iii)	When goods are sold on credit the buyer becomes the debtor of the seller. The relationship between the buyer and seller is that of debtor and creditor.	When goods are sold on credit, the buyer becomes debtor of the consignor. The relationship between the consignor and the consignee is that of a principal and agent.
(iv)	When goods are lost after the delivery to the buyer, it is the buyer who will bear the loss.	When goods are lost on consignment, it is the consignor who will bear the loss.
(v)	The expenses incurred by the buyer are to be borne by the buyer itself after the delivery of goods.	Expenses borne by the consignee to receive the goods and to store it safely is borne by the consignor. .

4. PRO-FORMA INVOICE

Along with the goods, a statement is usually forwarded by the consignor to the consignee, giving description of the goods consigned, the weight, quantity, price and other relevant details. Such a statement is known as pro-forma invoice. Pro-forma invoice is like ordinary invoice which is used at the time of normal buying and selling transactions. Practically, it gives an idea to the consignee about the price at which the goods will be disposed of. Generally, pro-forma invoice, includes a certain minimum amount of profit beyond which the consignee is not allowed to sell. Therefore, pro-forma invoice price is always higher than the actual cost price. Therefore, an adjustment is to be made at the end of the period in order to ascertain the correct amount of profit.

5. ACCOUNT SALES

This is a statement of accounts showing the gross and net proceeds of the consigned goods sold by the consignee for the account of the consignor. When the consignee has sold the goods at periodical intervals, the consignee submits to the consignor a statement showing:

- The gross proceeds of the goods sold by him.
- The charges or expenses incurred by him.
- His commission
- The net amount due to the consignor and the mode of remittance i.e. cash, cheque, draft, bill receivable, etc.

A specimen of the 'Account Sales' is given below:

Account Sales of 200 radio sets received from and sold on account on Teena & Co., Calcutta.

	<i>Rs.</i>	<i>Rs.</i>
150 Radio sets @ Rs.750 each	1,12,500	
50 Radio sets @ Rs.1,000 each	<u>50,000</u>	1,62,500
Less: Expenses		
	<i>Rs.</i>	
Freight	750	
Insurance	300	
Rent	<u>550</u>	1,600
Less: Commission @ 10%	<u>16,250</u>	<u>17,850</u>
		1,44,650
Less: Advance paid		<u>50,000</u>
Balance due remitted as per draft enclosed.		<u>94,650</u>

E. & O.E.

for Star & Sons

Madras, 5th June, 2007

(Sd/-).....

6. CONSIGNEE'S COMMISSION

Generally, the consignee is remunerated by a commission which is usually calculated as an agreed percentage of the gross proceeds of sale. When goods are sold by the consignee on credit, there is a possibility that the amount may not be realizable by the consignee from the consignment debtors. Since the consignee sells goods as an agent of the consignor and not on his own account, it is the consignor who runs the risk of bad debts arising from credit sales. The consignor, not being in direct contact with customers may wish to have a guarantee from the consignee that he will pay if the customers fail to make the payment. The consignee gives such guarantee for covering the risk of bad debts in return for an extra commission which is known as *del credere* commission. This commission is paid by the consignor to the consignee for taking additional risk of recovery of debts on account of sales made on credit by the consignee on behalf of the consignor. Sometimes, *del credere* commission is shown separately from and in addition to the ordinary commission, but very often the two commissions are merged into one percentage. If the consignor allows *del credere* commission to the consignee then bad debts will be borne by the consignee. Moreover, it will also make the consignee careful in choosing customers for credit sales.

In order to give further incentives, sometimes an extra commission termed as overriding commission is allowed to consignee in case the sales exceed a specified amount. Over-riding commission is allowed by the consignor to the consignee to promote sale at higher price than specified or to encourage consignee to put more work in introducing new product in the market. Besides being entitled to commission, the consignee is also entitled to be reimbursed for expenses incurred by him on behalf of consignor.

7. ACCOUNTING TREATMENT IN THE BOOKS OF CONSIGNOR

In order to ascertain profit or loss on consignment to a particular consignee, consignor maintains an account called Consignment Account. If goods are consigned to several consignees, consignor maintains as many consignment accounts as there are consignees. Then to distinguish different consignment accounts the names or places of consignees are added to consignment accounts. For example, a consignment account may be styled as Consignment to Bombay Account or Consignment to Kochi Account.

Consignment account is in the nature of Trading and Profit and Loss Account. On the debit side of consignment account, cost of the goods sent, expenses incurred in respect of goods so sent including commission payable to consignee on sales made by him and expenses incurred by him are recorded: on the credit side, sale proceeds and closing stock of goods consigned are recorded, the difference between the two sides represents profit earned or loss incurred and is transferred to Profit and Loss Account.

Consignor also maintains, the account of the consignee which show the amount due from consignee after the various transactions with him have been recorded.

Schemes of Entries

- (i) On despatch of goods to Consignee

Consignment Account	Dr.
To Goods Sent on Consignment Account	

- (ii) For expenses incurred by consignor in respect of the goods consigned:

Consignment Account	Dr.
To Cash Account/Bank	

- (iii) (a) For acceptance given by the Consignee

- | | |
|--------------------------|-----|
| Bills Receivable Account | Dr. |
| To Consignee | |
- (b) If consignee pays cash as advance
- | | |
|-------------------|-----|
| Cash Account/Bank | Dr. |
| To Consignee | |
- (iv) On consignee reporting Sale
- | | |
|------------------------|-----|
| Consignee | Dr. |
| To Consignment Account | |
- (v) For the expenses incurred by consignee and reported in the Account Sales
- | | |
|---------------------|-----|
| Consignment Account | Dr. |
| To Consignee | |
- (vi) For commission payable to the consignee
- | | |
|---------------------|-----|
| Consignment Account | Dr. |
| To Consignee | |
- (vii) For closing stock with the consignee
- | | |
|------------------------------|-----|
| Stock on Consignment Account | Dr. |
| To Consignment Account | |

At this stage if credit side of Consignment Account is heavier than the debit side, the difference is the profit and is credited to Profit and Loss Account and debited to Consignment Account. If the debit side of the Consignment Account is heavier than the credit side of the same account the difference represents loss and is debited to Profit and Loss Account and credited to Consignment Account. This closes the Consignment Account.

- (viii) For transfer of Profit from Consignment Account to Profit and Loss Account
- | | |
|----------------------------|-----|
| Consignment Account | Dr. |
| To Profit and Loss Account | |

A reverse entry will be passed if Consignment Account reveals loss.

In the next accounting period, Consignment Account starts with a debit for unsold and stock at the end of the previous accounting period.

- (ix) Goods Sent on Consignment Account must be transferred to Purchases Account in case of trading concern and to Trading Account in case of a manufacturing concern.

For transfer of goods Sent on Consignment Account to Purchases Account

- | | |
|-----------------------------------|-----|
| Goods Sent on Consignment Account | Dr. |
| To Purchases Account | |

- (x) For Cash received from consignee
- | | |
|-------------------|-----|
| Cash/Bank Account | Dr. |
| To Consignee | |

8. ACCOUNTING TREATMENT IN THE BOOKS OF CONSIGNEE

Consignment is not equivalent to a sale with the result the consignee is not a debtor until the sales are made to him. Thus no entry is made when goods are received by him on consignment. He may however, record the details of the goods received in a separate book, called Consignment Inward Book. The scheme of journal entries in consignee's books is as under.

- (i) For advance made to the consignor
- | | |
|----------------------------------|-----|
| Consignor | Dr. |
| To Bank or Bills Payable Account | |
- (ii) For payment of expenses in respect of consignment

	Consignor	Dr.
	To Cash or Bank Account	
(iii)	For Cash sale of goods	
	Bank	Dr.
	To Consignor	
(iv)	For credit sales	
	Consignment Debtors Account	Dr
	To Consignor	
(v)	For commission earned by him	
	Consignor	Dr.
	To Commission Account	
(vi)	For bad debts when no del credere commission is paid	
	Consignor	Dr.
	To Consignment Debtors Account	
(vii)	Bad debts arising when he is entitled to Del credere Commission	
	Bad Debts Account	Dr.
	To Consignment Debtors Account	
	<i>Note:</i> It is always appropriate to transfer bad debts to Commission Account.	
	Commission Account	Dr.
	To Bad Debts Account	
(viii)	For payment to consignor	
	Consignor	Dr.
	To Cash or Bank Account	

On the last date of the accounting year, if there is any balance (debit/credit) in the Consignor's Account it should be shown in the Balance Sheet under Sundry Debtors or Sundry Creditors depending upon the nature of the balance. The student should note that the consignee will not make any entry in respect of stock on consignment. Similarly he will not ascertain any profit or loss in respect of goods sold by him on behalf of the consignor. However, the commission received should be transferred to Profit and Loss Account at the year end.

9. VALUATION OF STOCK

The unsold stock remained with the consignee has to be valued at cost (plus rateable share of non-recurring expenses) or market price whichever is lower. Non-recurring expenses are the expenses which are incurred to bring the goods to the godowns of the consignee. For example, packing and forwarding charges, railway freight, octroi duty, insurance in transit, cartage of goods from railway station to the godowns of the consignee etc. But expenses incurred thereafter, for example godown rent, insurance charges to cover risks of loss while goods are in godown, salesmen's salary, advertising expenses, etc., are not considered for determining cost of goods remaining unsold. Cost of stock is not affected whether a particular expense is paid by the consignor or by the consignee. However, if the question does not give details of various expenses incurred, it should be assumed that expense paid by the consignor of non-recurring nature whereas those paid by the consignee are not so.

However, if it is assumed that the unsold stock will realise less than cost, the net realisable value (i.e. realisable value minus estimated expense including consignee's commission) is to be considered for the purpose. If the net realisable value is found to be less than cost, the stock must be written down accordingly since it is based on the principle of conservation i.e. anticipated losses must be provided for in the books.

Illustration 1:

Peter sent to Qureshi 1,000 pieces of goods on consignment basis; one piece costing Rs.

230. Peter sent Rs. 2,200 on packing, Rs. 450 on freight and Rs. 1,400 on insurance in transit. Qureshi paid octroi duty amounting to Rs. 1,200 and cartage Rs. 1,100 to bring goods to his godowns. In course of time Qureshi also spent Rs. 1,600 on insurance and rent of godown and paid Rs. 4,000 as salaries to salesman. Just before close of accounting period, Qureshi reported that he had sold 800 pieces at Rs. 305 per piece. Qureshi is entitled to a commission @ 5% of gross sales.

Show how the unsold stock will be valued and prepare Consignment Account in Peter's Ledger.

Solution:

Calculation of value of closing stock:

200 pieces @ Rs. 230 per piece Rs. 46,000

200/1000 th of non-recurring expenses:

Rs.		
Packing	2,200	
Freight	450	
Insurance in transit	1,400	
Octroi duty	1,200	
Cartage	1,100	
	<u>6,350</u>	<u>1,270</u>
		<u>47,270</u>

Dr.	Consignment Account	Cr.
	Rs.	Rs.
To Goods Sent on Consignment	2,30,000	By Qureshi (Sales) 2,44,000
To Cash (Expenses)	4,050	By Consignment Stock 47,270
To Qureshi (Expenses)	7,900	
To Qureshi (Commission)	12,200	
To Profit and Loss A/c	<u>37,120</u>	
	<u>2,91,270</u>	<u>2,91,270</u>

10. LOSS OF GOODS ON CONSIGNMENT

A part of the goods sent on consignment may be lost or destroyed or damaged either in transit or in the consignee's godown. Such loss may be either normal loss or abnormal loss.

Normal Loss

Any loss which is unavoidable, inherent and due to natural causes, such as evaporation, leakage, drying etc. is known as normal loss. No effort either by the consignor or by the consignee can prevent this loss. Since normal loss is a part of the cost of goods, no additional adjustment is required for this purpose. While calculating the value of stock on consignment, the cost is inflated to cover the normal loss. This is done by appropriating the cost on the basis of actual quantity available for sale. Thus, value of stock on consignment:

$$\frac{\text{Cost of goods consigned} \times \text{Unsold quantity}}{\text{Actual quantity available for sale}}$$

For example, suppose 1,000 tonnes of limestone is consigned @20 per tonne, freight thereon being Rs. 4,000. If the quantity sold is 600 tonnes and that unsold is 350 tonnes, it means that there is a normal loss 50 tonnes.

$$\text{Value of 350 tonnes will be} = \text{Rs. } \frac{20,000 + 4000}{950} \times 350$$

$$= \text{Rs. } \frac{24,000}{950} \times 350$$

$$= \text{Rs. } 8,842.10$$

Abnormal Loss

Abnormal loss of stock in consignment is caused by theft, accident, fire, pilferage, abnormal breakage, carelessness etc. Abnormal loss is calculated just the same way as the valuation of stock on consignment after taking into consideration the proportionate expenses incurred on it and is credited to consignment account and debited to profit and loss account. In case the stock is insured, consignment account is credited with the full cost of the goods so lost and abnormal loss account is debited. Any amount realised on account of damaged goods should be credited to abnormal loss account. The amount of claim receivable from the insurance company is debited to insurance company account and credited to abnormal loss account and the balance of abnormal loss is debited to profit and loss account. Later, when the amount is received from the insurance company, cash account is debited and insurance company account is credited. The journal entries will be as follows:

- (i) If not covered by Insurance Company

Profit and Loss A/c	Dr.
(Abnormal Loss A/c)	
To Consignment A/c	
- (ii) (a) If covered by Insurance Company

Abnormal Loss A/c	Dr.
To Consignment A/c	

 (b) For amount received from the insurance company.

Insurance Company A/c	Dr.
To Abnormal Loss A/c	
- (c) Balance of loss not covered by insurance company.

Profit and Loss A/c	Dr.
To Abnormal Loss A/c	

The amount of the loss is ascertained like the value of closing stock except that expenses incurred only after the loss had taken place have to be 'ignored' while calculating the 'cost' of the loss because no part of such expenses can be said to have been incurred on the lost goods. For example, suppose 100 kgs of a commodity is sent, cost is being Rs. 200 per kg and the consignor spending Rs. 600 by way of freight. Further, suppose 5 kgs of the commodity is badly damaged due to poor packing and is disposed of at the railway station itself. The consignee brings the balance of the goods to his godown paying cartage of Rs. 50. Now Consignment Account will be credited with Rs. 1,030, i.e.,

$$5 \times \text{Rs. } 200 + \frac{5}{100} \times 600$$

No part of cartage Rs. 50 will be included.

11. METHODS OF PREPARING CONSIGNMENT ACCOUNT

There are different methods of preparing Consignment Account. The methods differ due to the different basis on which goods consigned may be valued for records in the Consignment Account.

(a) Cost Price Method

Under this method, goods, consigned are recorded at cost price in Consignment Account. Briefly, the various steps can be outlined as follows:

- (i) Cost of goods sent is debited to Consignment Account and credited to Goods Sent on Consignment Account. Consignment Account is also debited with the amount of expenses incurred by the consignor in respect of the goods consigned, credit being to Cash or Bank as the case may be.
- (ii) When account Sale is received, Consignment Account is credited and Consignee is debited, with the gross sale proceeds of goods sold by the consignee. Consignment Account is debited and consignee is credited for expenses incurred by consignee on behalf of the consignor and for the commission earned by consignee on sales. If some payments are received from Consignee the same is credited to Consignee.
- (iii) To determine profit or loss when only a part of the goods consigned has been sold, the unsold stock is valued at cost plus rateable expenses incurred till the goods reached the godown of consignee or the market price whichever is less. The amount is credited to Consignment Account and debited to Consignment Stock Account.

(b) Invoice Price Method

Sometimes, the consignor does not prefer to disclose the real profit that is earned on consignment for many reasons. For this purpose, the consignor sends goods at pro-forma invoice price to the consignee which is fixed after adding certain percentage on cost or on sale/invoice price so that the consignee will not be able to know the profit which is earned by the consignor in the transaction. If there is any unsold stock or any abnormal loss they are to be valued at invoice price. Hence, in order to ascertain the true profit or loss on a consignment proper adjustments have to be made to eliminate such loading and bring down the items to cost level.

Under this method of dispatch of goods, Consignment Account is debited and Goods Sent on Consignment Account is credited with the 'Invoice' Price of goods sent:

But in order to ascertain Profit or Loss, sale proceeds have to be compared with cost of goods. Hence later, Goods Sent on Consignment Account is debited and Consignment Account is credited with the excess of 'invoice' price over cost (the excess is called 'loading') to adjust the two accounts.

Under this method, closing stock is also initially at 'Invoice' price plus rateable the share on non-recurring expenses. But again to adjust Consignment Account, the following entry is passed:

Consignment Account	Dr.	Loading included in the
To Consignment Stock Reserve A/c		value of closing stock

In the next accounting period, Consignment Stock Reserve is transferred to Consignment Account. All other entries in the books of the Consignor are the same as in Cost Method.

For loading on abnormal loss the entry will be:

Consignment A/c	Dr.
To Abnormal Loss A/c	

Illustration 2 :

On 1st September, 2007 Atul of Assam sent on consignment to Daulat of Delhi 100 cases of tea costing Rs. 500 each invoiced 'Pro-forma' at Rs. 600 each. Freight and other charges on the consignment amount to Rs. 3,100.

On 1st December, 2007 Daulat sent Account Sales Ledger with the necessary remittance

showing that 40 cases had realised Rs. 600 each and 30 cases Rs. 700 each and 30 cases remained in stock unsold. Rs. 2,500 was spent by Daulat for the consignment. Daulat was given a commission of 5% on sales. On 27th December Daulat informed Atul that 20 cases were damaged due to bad packing that they would be sold at Rs. 200 per case.

Both the firms close their books of account on 31st December. Prepare Ledger Account in the books on both the parties.

Solution:

In Atul's Ledger			
Dr.	Consignment of Delhi Account		Cr.
	Rs.		Rs.
To Goods Sent on Consignment	60,000	By Daulat (Sales)	
To Cash (Expenses)	3,100	40 x 600 =	24,000
To Daulat (Expenses)	2,500	30 x 700 =	<u>21,000</u>
To Daulat (Commission)	2,250		45,000
To Stock Reserve	1,000	By Goods Sent on Con-	
To Profit and Loss Account	3,080	signment (Loading)	10,000
		By Abnormal Loss	6,620
		By Closing Stock	
		Damaged	4,000
		Normal	<u>6,310</u>
	<u>71,930</u>		<u>71,930</u>

Daulat			
	Rs.		Rs.
To Consignment to Delhi (Sales)	45,000	By Consignment to Delhi A/c	
		(expenses)	2,500
		By Consignment to Delhi A/c	
		(commission)	2,250
		By Bank	<u>40,250</u>
	<u>45,000</u>		<u>45,000</u>

In Daulat's Ledger			
Atul			
	Rs.		Rs.
To Cash (expenses)	2,500	By Cash (sales)	45,000
To Commission	2,250		
To Bank	<u>40,250</u>		
	<u>45,000</u>		<u>45,000</u>

(c) Memorandum Column Method

It is a modification of Cost Price Method. Under this system additional amount columns are provided in Consignment Account and Goods Sent on Consignment Account to make memorandum entries regarding 'Invoice' price of goods consigned sold and remaining unsold.

12. ADVANCE BY CONSIGNEE

Sometimes, the consignee may advance a sum of money or accepts a bill of exchange against the value of the goods sent to him by the consignor. The amount so advanced or the amount of the bill so accepted is credited by consignor to the personal account of the consignee

maintained by the consignor in his ledger. The consignee in turn debits the account of consignor for such an advance or acceptance.

If the consignor receives an acceptance and gets it discounted, the discount should be debited to Discount Account and not to Consignee's Account.

The advance money so received will automatically be adjusted against the local dues for ascertaining the net amount payable to the consignor. The entire amount of advance money may be adjusted even if a part of goods are sold provided that such advance is not treated as caution money or security money. However, if the advance is treated by way of security, that portion of advance which relates to the goods lying unsold with the consignee must not be adjusted but should be carried forward. For example, a consignee advances Rs. 10,000 as security against goods consigned. Suppose, he sells $\frac{3}{4}$ th of the goods for Rs. 12,000 and is entitled to a commission of Rs. 480 and has incurred expenses amounting to Rs. 120 then the consignee will remit Rs. 3,900 (and not Rs. 1,400) so that a balance of Rs. 2,500 still remains in his account as advance against $\frac{1}{4}$ th of the goods remaining unsold.

13. RETURN OF DAMAGED GOODS BY CONSIGNEE

Sometimes, the goods which are damaged on account of some reasons or other like floods, fire or negligence in handling while in the possession of the consignee or no longer saleable by the consignee are returned to the consignor. The loss due to the damaged goods is generally transferred to Profit and Loss Account like abnormal loss of goods. The damaged goods returned must be valued at the cost or market price whichever is less without taking into consideration the proportionate expenses paid either by consignor or consignee or both. Proportionate expenses are taken into consideration only for calculating the value of stock at the end and the amount of abnormal loss. The following journal entry is passed for the goods returned by the consignee in the books of the consignor:

Goods Sent on Consignment Account	Dr.
To Consignment Account	

No entry is made by the consignee for this purpose. But when any expenses have been incurred by the consignee for return of such goods, the entry in the books of the consignor will be:

Consignment Account	Dr.
To Consignee	

In the books of consignee the entry will be:

Consignor	Dr.
To Bank	

14. FALL IN THE MARKET VALUE

When there is sudden fall in the market value of the goods consigned, the valuation of consignment stock should be done at the market price. Loss on valuation is not transferred to profit and loss account. It is automatically adjusted in the profit or loss on consignment itself. It must be noted that proportionate direct expenses have to be added to the market value of consignment stock.

Illustration 3 :

On 4th September, 2007 Dilip sent to Kuldeep on consignment basis goods costing Rs. 80,000 invoiced proforma at Rs. 1,00,000 and drew upon the latter a bill at 3 months for Rs. 50,000 which was immediately accepted by the latter. Freight and other expenses incurred by Dilip on the goods consigned amounted to Rs. 6,400.

On 21st December, 2007, Dilip received an Account Sales from Kuldeep along with a bank draft for the amount to settle the account up-to-date. According to Account Sales received,

Kuldeep had sold three-fourths of the goods for Rs. 87,000 and had incurred selling expenses amounting to Rs. 3,270. Kuldeep charge commission @5%.

Both the parties closed their account on 31st December, 2007.

Show journal entries to record the above mentioned transactions in the books of both the parties. Also show important Ledger Accounts in Dilip's Ledger. Dilip passed entries on the basis of invoice price of the goods consigned. The advance money received may be treated by way of security.

Solution:

**Dilip's Book
Journal Entries**

			<i>Dr.</i>	<i>Cr.</i>
			<i>Rs.</i>	<i>Rs.</i>
2007				
Sept. 4	Consignment Account	Dr.	1,06,400	
	To Goods Sent on Consignment A/c			1,00,000
	To Bank Account			6,400
	(Invoice price of goods sent to Kuldeep on consignment basis and expenses incurred on goods consigned)			
"	Bills Receivable Account	Dr.	50,000	
	To Kuldeep			50,000
	(Acceptance received from Kuldeep)			
Dec. 7	Bank Account	Dr.	50,000	
	To Bills Receivable Account			50,000
	(Cash received on maturity of bill)			
Dec. 21	Kuldeep	Dr.	87,000	
	To Consignment Account			87,000
	(Sale proceeds of three-fourth of Goods sold by Kuldeep)			
"	Consignment Account	Dr.	3,270	
	To Kuldeep			3,270
	(Expenses incurred by Kuldeep)			
2007			<i>Rs.</i>	<i>Rs.</i>
"	Consignment Account	Dr.	4,350	
	To Kuldeep			4,350
	(Commission payable to Kuldeep)			
"	Bank	Dr.	41,880	
	To Kuldeep			41,880
	(Amount of bank draft received from Kuldeep in settlement of account up-to-date; 1/4 of the advance remaining unadjusted)			
Dec. 31	Goods Sent on Consignment A/c	Dr.	20,000	
	To Consignment Account			20,000
	(Loading in the invoice price of goods sent on consignment)			
"	Stock on Consignment Account	Dr.	26,600	
	To Consignment Account			26,600

	(Invoice price of one-fourth of goods plus proportionate expenses incurred by consignor)		
"	Consignment Account	Dr.	5,000
	To Stock Reserve		5,000
	(Loading in the invoice price of one-fourth of the goods)		
"	Goods Sent on Consignment A/c	Dr.	80,000
	To Purchases Account/ Trading Account		80,000
	(Transfer of Goods Sent on Consignment Account)		
"	Consignment Account	Dr.	14,580
	To Profit and Loss Account		14,580
	(Transfer of profit on consignment to Profit and Loss Account)		

Ledger Accounts					
Consignment Account					
Dr.			Cr.		
2007		Rs.	2007		Rs.
Sept. 4	To Goods Sent on Consignment A/c	1,00,000	Dec. 21 By Kuldeep (Sales)		87,000
"	To Bank (Expenses)	6,400	Dec. 31 By Goods Sent on Consignment A/c		20,000
Dec. 21	To Kuldeep (expenses)	3,270	" By Stock on Consignment		26,600
"	To Kuldeep (commission)	4,350			
Dec. 31	To Stock Reserve	5,000			
"	To Profit and Loss Account (Profit)	14,580			
		<u>1,33,600</u>			<u>1,33,600</u>

Kuldeep's Account					
2007		Rs.	2007		Rs.
Dec. 21	To Consignment A/c (sales)	87,000	Sept. 4 By Bills Receivable A/c		50,000
Dec. 31	To Balance c/d (1/4 of advance)	12,500	Dec. 31 By Consignment A/c (expenses)		3,270
			By Consignment A/c (commission)		4,350
			By Bank A/c		41,880
		<u>99,500</u>			<u>99,500</u>

In Kuldeep's Books					
Journal Entries					
			Dr.		Cr.
2007			Rs.		Rs.
Sept. 4	Dilip	Dr.	50,000		
	To Bills Payable Account				50,000
	(Acceptance given to Dilip)				
Dec. 7	Bills Payable Account	Dr.	50,000		
	To Bank				50,000
	(Payment made as maturity of acceptance on the due date)				

Dec. 21	Cash A/c	Dr.	87,000	
	To Dilip			87,000
	(Sale proceeds of goods sold on behalf of Dilip)			
Dec. 21	Dilip	Dr.	3,270	
	To Cash Account			3,270
	(Expenses incurred on behalf of Dilip in regard to goods received on consignment)			
"	Dilip	Dr.	4,350	
	To Commission Received Account			4,350
	(Commission earned on sale made on behalf of Dilip)			
Dec. 31	Dilip	Dr.	41,880	
	To Bank			41,880
	(Bank draft sent to Dilip in settlement of account up to date; 1/4 of the advance remaining unadjusted)			
"	Commission Received Account	Dr.	4,350	
	To Profit and Loss Account			4,350
	(Transfer of Commission Received Account to Profit and Loss Account)			

Illustration 4:

On 1st October, 2007, B of Bombay consigned to A of Ahmedabad 100 Mobile sets. Cost of each set was Rs. 1,900 but B prepared pro-forma invoice at Rs. 2,200 per set. B incurred expenses amounting to Rs. 5,000 on goods consigned. On 31st December, 2007, A informed B that he had sold 68 sets @ 2,800 per set and 11 sets @ Rs. 2,700 per set and had spent Rs. 15,200 on behalf of the consignor. One set has been accidentally damaged and sold for Rs. 500 according to instructions of the consignor. A was entitled to a commission of 6% on gross sales including *del credere* commission. A could recover only Rs. 2,500 from a customer to whom one set has been sold on credit for Rs. 2,800. All other sales were made on cash basis.

Show ledger accounts in the books of both the parties.

Solution:

Cost Method

B's Ledger Accounts					
Consignment Account					
<i>Dr.</i>			<i>Cr.</i>		
	<i>Rs.</i>			<i>Rs.</i>	
To Goods Sent on Consignment A/c	1,90,000	By A (sales of normal sets)			
To Cash (expenses)	5,000	(68 x 2,800 = 1,90,400)			
To A (expenses)	15,200	(11 x 2,700 = 29,700)		2,20,100	
To A (commission)	13,206	By Abnormal Loss		1,950	
To Profit and Loss A/c	37,644	By Stock on Consignment		39,000	
	<u>2,61,050</u>			<u>2,61,050</u>	
Goods Sent on Consignment Account					
	<i>Rs.</i>			<i>Rs.</i>	
To Trading A/c	<u>1, 90,000</u>	By Consignment A/c		<u>1, 90,000</u>	
Abnormal Loss Account					
	<i>Rs.</i>			<i>Rs.</i>	

To Consignment Account	1,950	By A (Sales)	500
To A (Commission)	<u>30</u>	By Profit & Loss A/c transfer	<u>1,480</u>
	<u>1,980</u>		<u>1,980</u>

A's Account

	Rs.		Rs.
To Consignment Account	2, 20,100	By Consignment Account	15,200
To Abnormal Loss Account	500	By Consignment Account	13,206
		By Abnormal Loss Account	30
		By Balance c/d	<u>1, 92,164</u>
	<u>2, 20,600</u>		<u>2, 20,600</u>
To Balance b/d	1, 92,164		

Invoice Method

Consignment Account

	Rs.		Rs.
To Goods Sent on Consignment A/c	2,20,000	By A	2,20,100
To Cash (Expenses)	5,000	By Abnormal Loss Account	1,950
To A (Expenses)	15,200	By Goods Sent on Consignment (loading)	30,000
To A (Commission)	13,206	By Stock on Consignment	45,000
To Stock Reserve	6,000		
To Profit & Loss A/c	<u>37,644</u>		
	<u>2,97,050</u>		<u>2,97,050</u>

Goods Sent on Consignment Account

	Rs.		Rs.
To Consignment A/c (loading)	30,000	By Consignment A/c	2,20,000
To Trading A/c (transfer)	<u>1, 90,000</u>		
	<u>2, 20,000</u>		<u>2, 20,000</u>

There will be no change in Abnormal Loss Account and the Account of A.

Memorandum Column Method

Dr.	Consignment Account				Cr.
	Invoice Price Rs.	Cost Price Rs.		Invoice Price Rs.	Cost Price Rs.
To Goods Sent on Consignment A/c	2,20,000	1,90,000	By A (sales)	1,73,800	2,20,100
To Cash (Expenses)	5,000		By Abnormal Loss	2,200	1,950
To A (Expenses)	15,200		By Stock on Consignment A/c	44,000	39,000
To A (Commission)	13,206				
To Profit and Loss A/c		<u>37,644</u>			
	<u>2,20,000</u>	<u>2,61,050</u>		<u>2,20,000</u>	<u>2,61,050</u>

Goods Sent on Consignment Account				
	<i>Invoice Price Rs.</i>	<i>Cost Price Rs.</i>		<i>Invoice Price Rs.</i> <i>Cost Price Rs.</i>
To Trading Account (transfer)	2,20,000	1,90,000	By Consignment Account	2,20,000 1,90,000

Other accounts will be the same in other methods.

A's Ledger Accounts B's Account				
	<i>Rs.</i>			<i>Rs.</i>
To Cash (Expenses)	15,200	By Cash (Normal Cash Sales)	2, 17,300	
To Commission (13,206 + 30)	13,236	By Debtors (Credit Sale)		2,800
To Balance c/d	<u>1, 92,164</u>	By Cash (Sale of damaged set)		<u>500</u>
	<u>2, 20,600</u>			<u>2, 20,600</u>
		By Balance b/d		1, 92,164

Debtors				
	<i>Rs.</i>			<i>Rs.</i>
To B (Credit Sale)	2,800	By Cash Account		2,500
	<u>2,800</u>	By Bad Debts		<u>300</u>
				<u>2,800</u>

Profit and Loss Account				
	<i>Rs.</i>			<i>Rs.</i>
To Bad Debts	300	By Commission		13,236

N B. Alternatively, Bad Debts may also be transferred to Commission Account.

Illustration 5

R of Ranchi consigned goods of the invoice price of Rs. 2,00,000 which is 25% above cost, to D of Delhi on the following conditions:

- Consignee to get a commission of 5% on all sales.
- Any goods taken by the consignee himself or lost through consignee's negligence shall be valued at cost plus 12-1/2% and no commission would be allowed on them.

The expenses incurred by the consignor were carriage and freight Rs. 6,720 and insurance Rs. 3,440.

The consignor received Rs. 50,000 as advance against the consignment. Account sales together with a draft for the balance due was received by the consignor showing the following position: Goods of the invoice price of Rs. 1,60,000 were sold for Rs. 2,48,000. Goods of the invoice price of Rs. 10,000 and Rs. 5,000 were taken by D and lost through his negligence, respectively. Amount of Rs. 1,720 on advertisement and Rs. 1,080 on selling expenses were

incurred by D.

Prepare consignment account and consignee's account in the books of the consignor.

Consignment Account			
Dr.			Cr.
	Rs.		Rs.
To Goods Sent on Consignment A/c	2, 00,000	By D (sales)	2, 48,000
To Bank (carriage and freight)	6,720	By D (see working note 1)	13,500
To Bank (insurance)	3,440	By Goods Sent on Consignment A/c (loading)	40,000
To D (expenses)	2,800	By Stock on Consignment A/c	26,270
To D (commission)	12,400		
To Stock Reserve A/c	5,000		
To Profit and Loss A/c	<u>97,410</u>		
	<u>3, 27,770</u>		<u>3, 27,770</u>

D's (Consignee's) Account			
	Rs.		Rs.
To Consignment A/c	2,48,000	By Bank	50,000
To Consignment A/c	13,500	By Consignment A/c (expenses)	2,800
		By Consignment A/c (commission)	12,400
		By Bank	<u>1,96,300</u>
	<u>2,61,500</u>		<u>2,61,500</u>

Working Notes:

(1) *Value of goods lost and taken by D*

	Rs.
Goods taken (invoice value)	10,000
Goods lost (invoice value)	<u>5,000</u>
	15,000
Less: Profit margin (20% or 1/5th)	<u>3,000</u>
Cost price of the goods	12,000
Add: 12-1/2% extra	<u>1,500</u>
Total	<u>13,500</u>

(2) *Value of closing stock*

Invoice value of stock = (2, 00,000 – 1, 60,000 – 10,000 – 5,000)	25,000
Add : Proportionate Expenses	Rs.
Freight	6,720
Insurance	<u>3,440</u>
Total	<u>10,160</u>
1/8th of total expenses	<u>1,270</u>
	<u>26,270</u>

As the stock left (Rs. 25,000) is 1/8th of the total invoice value of goods (Rs. 2,00,000), 1/8th of the total expense to be added.

(3) *Stock Reserve*

In view of the fact that the margin is added on the cost of goods sent the amount of margin on

the closing balance of consignment stock would be:

20% of Rs. 25,000 = Rs. 5,000

Illustration 6

Punjab Cycle Co. of Ludhiana consigned 100 bicycles to Kanpur Cycle Co. of Kanpur costing Rs. 1,500 each, invoiced at Rs. 2,000 each. The consignor paid freight Rs. 10,000 and insurance in transit Rs. 1,500. During transit, 10 bicycles were totally damaged.

Kanpur Cycle Co. took delivery of the remaining bicycles and paid Rs. 1,530 for octroi duty. Kanpur Cycle Co. sent a bank draft to Punjab Cycle Co. for Rs. 50,000 as advance and later on sent an account sales showing that 80 bicycles had been sold @ Rs. 2,200 each. Expenses incurred by Kanpur Cycle Co. on godown rent were Rs. 2,000. Kanpur Cycle Co. is entitled to a commission of 5% on invoice price and 25% on any surplus of sale price over invoice price. Insurance claim was settled at Rs. 14,000.

Prepare consignment account, consignee's account and abnormal loss account in the books of the consignor.

Solution:

**Books of Punjab Cycle Co.
Consignment Account**

Dr.					Cr.
	Rs.	Rs.			Rs.
To Goods Sent on Consignment A/c		2,00,000	By Goods Sent on Consignment A/c		50,000
To Cash A/c (expenses)			By Kanpur Cycle Co.		
Freight	10,000		(Sales — 80 x Rs. 2,200)	1,76,000	
Insurance	<u>1,500</u>	11,500	By Abnormal Loss A/c	16,150	
To Kanpur Cycle Co.			By Consignment Stock A/c	21,320	
Octroi	1,530				
Godown Rent	<u>2,000</u>	3,530			
To Kanpur Cycle Co.					
Commission		12,000			
To Consignment Stock Reserve		5,000			
To Profit and Loss A/c		31,440			
		<u>2,63,470</u>			<u>2,63,470</u>

Abnormal Loss A/c

	Rs.		Rs.
To Consignment A/c	16,150	By Insurance Claim Account/ Bank	14,000
	<u>16,150</u>	By Profit and Loss A/c	<u>2,150</u>
			<u>16,150</u>

Kanpur Cycle Co.'s A/c

	Rs.		Rs.
To Consignment A/c	1,76,000	By Bank (advance)	50,000
		By Consignment A/c	
		— Octroi	1,530
		— Godown Rent	2,000
		— Commission	12,000
		By Balance c/d	<u>1,10,470</u>
	<u>1,76,000</u>		<u>1,76,000</u>

To Balance b/d 1,10,470

Working Notes:

1. *Abnormal Loss:*

Cost of 10 bicycles (10 x 1,500)	15,000
Add: Proportionate expenses of consignor	<u>1,150</u>
	<u>16,150</u>

2. *Calculation of unsold stock:*

Invoice price of 10 bicycles (10 x Rs. 2,000)	20,000
Add: Proportionate expenses of consignor	1,150
Proportionate expenses of consignee — Octroi	<u>170</u>
	<u>21,320</u>

3. *Calculation of commission payable to the consignee*

(i) 5% of invoice price of 80 cycles	8,000
(ii) 25% on surplus price	<u>4,000</u>
	<u>12,000</u>

4. Loading on goods sent on consignment (100 x 500)	50,000
5. Stock Reserve	<u>5,000</u>

II. ACCOUNTING FOR JOINT VENTURES

15. MEANING OF JOINT VENTURE

When two or more parties, normally carrying on business independently of one another, join together to exploit particular business opportunity where their individual capabilities can be profitably pooled and share profits resulting from that particular business opportunity in the agreed ratio, there comes into existence a joint venture. In other words, it is a very short duration business entered into by two or more persons jointly. Joint Venture may be limited to one transaction or may extend to a number of transactions. It may be even for a specified period of time. If there is no agreement to the contrary, the parties (called co-venturers) share profits and losses equally.

Joint Venture is in the nature of partnership but without a firm name and only relating to a specified field of activity. Suppose A and B are building contractors and they enter into a joint venture to construct a big Government building. In this case, A and B share profits and losses resulting from the particular contract with the Government. A and B may be having other separate contracts also but A will not share any profit or loss regarding other contracts entered into by B and similarly B will not be entitled to share the profits or liable to bear part of losses resulting from other contracts entered into by A.

16. FEATURES OF JOINT VENTURE

- (i) It is a short duration special purpose partnership.
- (ii) It does not entail a continuing partnership, since termination is certain.
- (iii) The business is dissolved after the venture is terminated.
- (iv) Ascertainment of income is relatively simple.
- (v) All the assets are ultimately received in cash and all liabilities are paid in cash.
- (vi) Application of many accounting concepts are dispensed with, such as the going concern concept.
- (vii) It does not use firm name.
- (viii) The co-venturers share profit or loss in the agreed ratio. In the absence of an agreement it is assumed to be equal.

17. DIFFERENCE BETWEEN JOINT VENTURE AND CONSIGNMENT

- (i) *Parties* : the parties to a joint venture are called co-venturers whereas in consignment they are called consignor and consignee.
- (ii) *Relationship* : The relationship between co-venturers is that of partners whereas in consignment they are called consignor and consignee is that of principal and agent.
- (iii) *Powers* : Co-venturers enjoy full powers as to sale and purchase of goods and collection of dues etc. Consignee being an agent has to obey the instructions of the principal.
- (iv) *Sharing Profits* : The co-venturers are entitled to share in profits whereas consignee is usually given commission for his services by the principal.
- (v) *Scope* : Consignment is concerned only with the sale of movable goods. Joint venture may be undertaken for any type of legal business e.g. construction of roads, buildings, making films, underwriting shares and debentures etc. in addition to purchase and sale of goods.
- (vi) *Capital Contribution* : Generally all co-venturers contribute funds (capital) to carry out the activities of joint venture. In the case of consignment, consignee does not contribute funds.
- (vii) *Number of Persons* : In consignment there are normally two parties, namely the principal and agent. The number of co-venturers will be at least two though it maybe more than two with equal status.

18. ACCOUNTING TREATMENT OF JOINT VENTURES

Record of transaction in respect of a joint venture can be made in either of two ways. Either the parties to the joint venture may record the various transactions only in their respective books of account or they may also maintain a separate set of books to record the transactions relating to the joint venture. The second course is adopted when the joint venture is of a sufficiently large magnitude.

(i) *When No Separate Set of Books is Maintained*

Under this method accounts with respect of joint venture transactions are kept in the books of each co-venturer. Co-venturers are generally engaged in their own business. They have books of account of their respective business. Additional accounts with respect of joint venture transactions are opened in their respective books. When accounts are maintained in the books of each co-venturer, one of the two approaches may be adopted.

(a) *Record in Each Party's Books* : Under this approach, each co-venturer maintains two accounts:

- (1) *Joint Venture Account* : It is a nominal account prepared to find out profit or loss of the venture. It contains all expenses, cost of goods sold, sales etc., balance being the profit or loss.
- (2) *Personal Account of the other Co-venturers* : It contains his investments for joint venture, his receipts and sales effected by him. This account is prepared to find out the amount due from him or due to him. The accounting procedures are as under:

Each venturer records the transaction undertaken by him by debiting Joint Venture Account with all costs and expenses and crediting with all sales and gains. For all items of cost and expenses defrayed by the other venturer, Joint Venture Account is debited and his personal account is credited. For all revenue received by the other venturer, his personal account is debited and Joint Venture Account is credited. Advances by one venturer to the other are recorded in the recipient's books by debiting Bank Account and crediting the personal account of the venturer making the advance. In the books of the venturer making the advance, the personal account of the recipient is debited and Bank Account is credited.

1. When an expenditure is incurred on account of joint venture:
Joint Venture Account Dr.
To Cash/Bank Account
2. When goods are taken out of the stock to be used in Joint Venture:
Joint Venture Account Dr.
To Purchases Account/Trading Account
3. When an expenditure is incurred or goods are supplied by the other party for Joint Venture:
Joint Venture Account Dr.
To Other Party's Account
4. If an acceptance is received from the other party:
Bill Receivable Account Dr.
To Other Party's Account
5. If the acceptance is discounted:
Cash Account Dr.
Joint Venture Account Dr. (with discount)
To Bills Receivable Account
6. If an acceptance is given to the other party:
Other Party's Account Dr.
To Bills Payable Account
7. For discount, when the other party gets the bills discounted:
Joint Venture Account Dr.
To Other Party's Account
8. When cash is received from third party on account of Joint Venture:
Bank/Cash Account Dr.
To Joint Venture Account
9. When cash is received by the other party on account of Joint Venture:
The Other Party's Account Dr.
To Joint Venture Account
10. If any special commission or salary etc., is receivable on account of Joint Venture:
Joint Venture Account Dr.
To Commission Account/Salary Account
11. If any special commission or salary, etc., is receivable by the other party on account of Joint Venture:
Joint Venture Account Dr.
To Other Party's Account
12. If unsold goods are taken over:
Purchases Account Dr.
To Joint Venture Account
13. If unsold goods are taken over by the other party:
Other Party's Account Dr.
To Joint Venture Account

14. To transfer the profit on account of Joint Venture:

Joint Venture Account Dr.
 To Other Party's Account
 To Profit and Loss Account

In case of loss, the abovementioned entry will be reversed.

15. On settlement of account with the other party:

Other Party's Account
 To Cash/Bank Account
 OR
 Cash/Bank Account
 To Other Party's Account.

Illustration 7

On 1st January 2007 B and C entered into a joint venture sharing the profits in the ratio of 3:2 after allowing a salary of Rs. 2000 p.m. to C. B sent out of his stock of goods costing Rs.5,00,000 to be sold by the latter and incurred expenses amount to Rs. 10,700. On 3rd January, 2007, C accepted a bill of exchange at 2 months for Rs. 3, 00,000 drawn by B. On 6th January, 2007, B discounted the bill @ 9% p.a. By 31st March, 2007 C had sold goods for Rs. 6, 00,500 after incurring expenses amounting to Rs. 11,450. C agreed to take over the remaining goods for Rs. 20,000. C forwarded a cheque immediately to settle the account. Show the Journal and Ledger Account in the books of B and C.

Solution :

		B's Book		
		Journal Entries		
			<i>Dr.</i>	<i>Cr.</i>
2007			<i>Rs.</i>	<i>Rs.</i>
Jan. 1	Joint Venture Account	Dr.	5,10,700	
	To Purchases Account/Trading A/c			5,00,000
	To Cash Account			10,700
	(Cost of goods taken of stock for joint venture and expenses incurred on account of the joint venture)			
Jan. 3	Bills Receivable Account	Dr.	3, 00,000	
	To C's A/c			3, 00,000
	(Acceptance received from C)			
"	Bank Account	Dr.	2, 95,500	
	Joint Venture Account	Dr.	4,500	
	To Bills Receivable Account			3, 00,000
	(Acceptance discounted and discount charged to joint venture account)			
Mar. 31	C's Account	Dr.	6, 00,500	
	To Joint Venture Account			6, 00,500
	(Sales made by C on account of joint venture)			
"	Joint Venture Account	Dr.	11,450	
	To C's Account			11,450
	(Expenses incurred by C on account of joint venture)			

"	C's Account	Dr.	20,000	
	To Joint Venture Account			20,000
	(Agreed value of goods taken over by C)			

2007			Rs.	Rs.
"	Joint Venture Account	Dr.	6,000	
	To C's Account			6,000
	(Salary allowed to C for 3 months @ Rs. 2,000 p.m.)			
"	Joint Venture Account	Dr.	87,850	
	To C's Account			35,140
	To Profit and Loss Account			52,710
	(Transfer of profit)			
"	Bank	Dr.	2,67,910	
	To C's Account			2,67,910
	(Amount received from C in settlement)			

Ledger Accounts							
Dr.		Joint Venture Account			Cr.		
2007		Rs.		2007		Rs.	
Jan.	1	To Purchases Account/ Trading Account	5,00,000	Mar. 27	By C (sales)	6,00,500	
"	1	To Cash (expenses)	10,700	Mar. 31	By C (agreed value of goods taken over by C)	20,000	
"	6	To Bills Receivable Account (discount)	4,500				
Mar.	31	To C (expenses)	11,450				
		To C (salary)	6,000				
		To C (2/5th profit)	35,140				
		To Profit and Loss A/c (3/5th profit)	52,710				
			<u>6,20,500</u>			<u>6,20,500</u>	

C's Account					
2007		Rs.	2007		Rs.
Mar. 31	To Joint Venture (sales)	6,00,500	Jan. 3	By Bills Receivable A/c	3,00,000
"	To Joint Venture (goods taken over)	20,000	Mar. 31	By Joint Venture A/c (expenses)	11,450
			"	By Joint Venture A/c (salary)	6,000
			"	By Joint Venture A/c (profit)	35,140
			"	By Bank (cheque)	2,67,910
		<u>6,20,500</u>			<u>6,20,500</u>

Bills Receivable Account					
2007		Rs.	2007		Rs.
Jan. 3	To C's A/c	3,00,000	Jan. 6	By Bank Account	2,95,500
				By Joint Venture A/c (discount)	4,500
		<u>3,00,000</u>			<u>3,00,000</u>

**C's Books
Journal Entries**

			<i>Dr.</i>	<i>Cr.</i>
<i>2007</i>			<i>Rs.</i>	<i>Rs.</i>
Jan. 1	Joint Venture Account	Dr.	5,10,700	
	To B's Account			5,10,700
	(Cost of goods supplied and expenses incurred by B)			
Jan. 3	B's Account	Dr.	3,00,000	
	To Bill Payable Account			3,00,000
	(Acceptance given to B)			
Jan. 6	Joint Venture Account	Dr.	4,500	
	To B's Account			4,500
	(Discount on acceptance)			
Mar. 6	Bills Payable Account	Dr.	3,00,000	
	To Cash Account			3,00,000
	(Payment of cash on maturity of acceptance)			
Mar. 31	Cash A/c	Dr.	6,00,500	
	To Joint Venture Account			6,00,500
	(Sales made on account of joint venture)			
"	Joint Venture Account	Dr.	11,450	
	To Cash Account			11,450
	(Expenses incurred on account of joint venture)			
"	Joint Venture Account	Dr.	6,000	
	To Salary Account			6,000
	(Salary for the month @ Rs. 2,000 p.m.)			
"	Purchases Account	Dr.	20,000	
	To Joint Venture Account			20,000
	(Goods taken over)			
"	Joint Venture Account	Dr.	87,850	
	To B's Account			52,710
	To Profit and Loss Account			35,140
	(Transfer of profit)			
"	B's A/c	Dr.	2,67,910	
	To Bank			2,67,910
	(Cheque forward to B settle the account)			

Ledger Accounts
Joint Venture Account

Dr.					Cr.	
2007		Rs.	2007		Rs.	
Jan.1	To B (goods and expenses)	5,10,700	Mar. 31	By Cash (sales)	6,00,500	
			"	By Purchases	20,000	
Jan. 6	To B (discount)	4,500				
Mar. 31	To Cash (expenses)	11,450				
"	To Salary	6,000				
"	To B (3/5th profit)	52,710				
"	To Profit and Loss Account (2/5th					

profit)	35,140	
	<u>6,20,500</u>	<u>6,20,500</u>

B's Account

2007		Rs.	2007		Rs.
Jan. 3	To Bills Payable A/c	3,00,000	Jan. 1	By Joint Venture A/c	5,10,700
Mar. 31	To Bank	2,67,910	" 6	By Joint venture (discount)	4,500
		<u>5,67,910</u>	Mar. 31	By Joint Venture	<u>52,710</u>
					<u>5,67,910</u>

(b) *Memorandum Method* : Under this methods accounts are prepared in the books of each co-venturer. Each co-venturer prepares the following accounts:

- (1) Memorandum Joint Venture Account
- (2) Joint Venture with (Co-venturer) Account

The Memorandum Joint Venture Account is exactly the same in the books of the both the co-venturers. Hence, each venturer prepares this account in order to ascertain the profit or loss on the venture taking into consideration his own as well as the co-venturer's transactions. This account resembles a Trading and Profit and Loss Account but does not form part of double entry books. It is prepared as a memoranda i.e. transactions are directly entered without going through the process of journal.

Joint Venture with (Co-venturer) Account is treated as a personal account in which each venturer records only such transactions as he undertakes, all costs and expenses are debited to this account and all sales and gains are credited to it. No account is taken of goods used or cash spent on joint venture by the other party. If any cash or acceptance is received on account of joint venture, from the other party, the amount should be credited to this account. This account is also debited with own share of profit, the credit being given to profit and loss account. In case the Memorandum Joint Venture Account shows a loss, it is credited to this account by debiting profit and loss account. The balance of this account will show the amount due from or due to the co-venturer. Journal entries are made as follows:

- (1) For goods supplied and expenses incurred by oneself

Joint Venture with... Account	Dr.	
To Cash Account		
(for cash purchases and expenses)		
To Purchases Account		
(for goods supplied out of stock)		
- (2) For sale proceeds received by oneself (not the other party)

Cash Account	Dr.	
To Joint Venture with... Account		
- (3) For interest and commission due to oneself (not the other party) on account of joint venture

Joint Venture with... Account	Dr.	
To Interest Account		
To Commission Account		
- (4) Amount paid to other party on account of the joint venture

Joint Venture with... Account	Dr.	
-------------------------------	-----	--

In case the amount is received from the other party in the joint venture, entry is reversed.

- | Purchases Account | | Dr. |
|-------------------|------|-----|
| 10-1-19 | 1000 | |
| 10-2-19 | 1000 | |
| 10-3-19 | 1000 | |
| 10-4-19 | 1000 | |
| 10-5-19 | 1000 | |
| 10-6-19 | 1000 | |
| 10-7-19 | 1000 | |
| 10-8-19 | 1000 | |
| 10-9-19 | 1000 | |
| 10-10-19 | 1000 | |
| 10-11-19 | 1000 | |
| 10-12-19 | 1000 | |
| 10-13-19 | 1000 | |
| 10-14-19 | 1000 | |
| 10-15-19 | 1000 | |
| 10-16-19 | 1000 | |
| 10-17-19 | 1000 | |
| 10-18-19 | 1000 | |
| 10-19-19 | 1000 | |
| 10-20-19 | 1000 | |
| 10-21-19 | 1000 | |
| 10-22-19 | 1000 | |
| 10-23-19 | 1000 | |
| 10-24-19 | 1000 | |
| 10-25-19 | 1000 | |
| 10-26-19 | 1000 | |
| 10-27-19 | 1000 | |
| 10-28-19 | 1000 | |
| 10-29-19 | 1000 | |
| 10-30-19 | 1000 | |
| 10-31-19 | 1000 | |
| 11-1-19 | 1000 | |
| 11-2-19 | 1000 | |
| 11-3-19 | 1000 | |
| 11-4-19 | 1000 | |
| 11-5-19 | 1000 | |
| 11-6-19 | 1000 | |
| 11-7-19 | 1000 | |
| 11-8-19 | 1000 | |
| 11-9-19 | 1000 | |
| 11-10-19 | 1000 | |
| 11-11-19 | 1000 | |
| 11-12-19 | 1000 | |
| 11-13-19 | 1000 | |
| 11-14-19 | 1000 | |
| 11-15-19 | 1000 | |
| 11-16-19 | 1000 | |
| 11-17-19 | 1000 | |
| 11-18-19 | 1000 | |
| 11-19-19 | 1000 | |
| 11-20-19 | 1000 | |
| 11-21-19 | 1000 | |
| 11-22-19 | 1000 | |
| 11-23-19 | 1000 | |
| 11-24-19 | 1000 | |
| 11-25-19 | 1000 | |
| 11-26-19 | 1000 | |
| 11-27-19 | 1000 | |
| 11-28-19 | 1000 | |
| 11-29-19 | 1000 | |
| 11-30-19 | 1000 | |
| 12-1-19 | 1000 | |
| 12-2-19 | 1000 | |
| 12-3-19 | 1000 | |
| 12-4-19 | 1000 | |
| 12-5-19 | 1000 | |
| 12-6-19 | 1000 | |
| 12-7-19 | 1000 | |
| 12-8-19 | 1000 | |
| 12-9-19 | 1000 | |
| 12-10-19 | 1000 | |
| 12-11-19 | 1000 | |
| 12-12-19 | 1000 | |
| 12-13-19 | 1000 | |
| 12-14-19 | 1000 | |
| 12-15-19 | 1000 | |
| 12-16-19 | 1000 | |
| 12-17-19 | 1000 | |
| 12-18-19 | 1000 | |
| 12-19-19 | 1000 | |
| 12-20-19 | 1000 | |
| 12-21-19 | 1000 | |
| 12-22-19 | 1000 | |
| 12-23-19 | 1000 | |
| 12-24-19 | 1000 | |
| 12-25-19 | 1000 | |
| 12-26-19 | 1000 | |
| 12-27-19 | 1000 | |
| 12-28-19 | 1000 | |
| 12-29-19 | 1000 | |
| 12-30-19 | 1000 | |
| 12-31-19 | 1000 | |
| 1-1-20 | 1000 | |
| 1-2-20 | 1000 | |
| 1-3-20 | 1000 | |
| 1-4-20 | 1000 | |
| 1-5-20 | 1000 | |
| 1-6-20 | 1000 | |
| 1-7-20 | 1000 | |
| 1-8-20 | 1000 | |
| 1-9-20 | 1000 | |
| 1-10-20 | 1000 | |
| 1-11-20 | 1000 | |
| 1-12-20 | 1000 | |
| 1-13-20 | 1000 | |
| 1-14-20 | 1000 | |
| 1-15-20 | 1000 | |
| 1-16-20 | 1000 | |
| 1-17-20 | 1000 | |
| 1-18-20 | 1000 | |
| 1-19-20 | 1000 | |
| 1-20-20 | 1000 | |
| 1-21-20 | 1000 | |
| 1-22-20 | 1000 | |
| 1-2 | | |

(6) For own share of profit on joint venture calculated by preparing Memorandum Joint Venture Account

Joint Venture with... Account Dr.

In case of loss, above entry is reversed.

In case co-venturers invest into or receive from joint venture different amount on different dates, the agreement between the parties may provide for the calculation of interest. The interest is calculated on amount invested in joint venture and also on the amount received on behalf of joint venture on the basis of the period. The following factors are to be considered:

- (i) Interest receivable by the venturers on the amounts invested in the joint venture is a gain to them and interest payable by them on the amounts received by them is a loss to them;
- (ii) Only the net interest receivable from or payable to the co-venturer is recorded in Joint Venture or Memorandum Joint Venture Account;
- (iii) The net amount of interest must be entered in the Joint Venture or Memorandum Joint Venture Account before ascertaining profit or loss on the venture;
- (iv) Interest on cash transactions involving bills accepted or drawn are not entered in the Joint Venture Account or Memorandum Joint Venture Account because the interest is a charge affecting the parties themselves and not an expense of joint venture.

On 1st January, 2007 P and Q entered into a Joint Venture to underwrite 10,000 equity shares of Rs. 25 each for a commission of 4% on issue price of share which were issued at par, the entire amount being payable on application and allotment. the public took up 9,500 shares.

The underwrites were to bear all expenses of issue of shares. These expenses were met by P on 1st January, 2007 and amounted to Rs. 1,400. On 1st February 2007 Q paid for 500 shares which had to be taken up by the underwriters after deducting commission due from the company. Q sold 400 shares for Rs. 9,600 on 1st March, 2007. Joint Venture was closed on 31st March, 2007 when Q sold the remaining shares @ Rs. 24.50 per share.

It was decided to share profits and losses equally after charging and allowing interest @ 6% per annum on receipts and payments by the participants.

Prepare ledger accounts in the books of both the parties assuming that the accounts were settled on 31 March, 2007.

Note : Underwriting is giving a guarantee to the company that the shares offered by the company to the public will be taken up by public and if some of them are not so taken up, the persons giving the guarantee (called underwriters) will take them up and pay for them. Underwriting commission payable to the underwriters is calculated on the value of all the shares underwritten and not only on the value of shares which have to be taken up by the underwriters.

**P's Ledger
Joint Venture Account**

Dr.				Cr.			
2007			Rs.	2007			Rs.
Jan. 1	To	Cash (expenses)	1,400	Mar. 1	By	Q (Sale of 400 shares)	9,600
Feb. 1	To	Q (payment to company)	2,500	Mar. 31	By	Q (Sales of 100 shares)	2,450
Mar. 31	To	Interest	21	"	By	Q (Interest)	23
"	To	Q (1/2 profit)	4,076				
"	To	Profit and Loss A/c (1/2 profit)	4,076				
			<u>12,073</u>				<u>12,073</u>

Q's Account

2007			Rs.	2007			Rs.
Mar. 1	To	Joint Venture	9,600	Feb. 1	By	Joint Venture	2,500
" 31	To	Joint Venture	2,450	Mar. 31	By	Joint Venture	4,076
"	To	Joint Venture	23	"	By	Cash A/c	5,497
			<u>12,073</u>				<u>12,073</u>

**In Q's Ledger
Joint Venture Account**

2007		Rs.	2007		Rs.
Jan. 1	To P (expenses)	1,400	Mar. 1	By Cash	9,600
Feb. 1	To Cash	2,500	Mar. 31	By Cash	2,450
Mar. 31	To P (interest)	21	Mar. 31	By Interest	23
Mar. 31	To P (profit)	4,076			
"	To Profit and Loss				
	Account (profit)	<u>4,076</u>			
		12,073			<u>12,073</u>

P's Account

Dr.				Cr.			
2007				Rs.			
Mar. 31	To	Cash	5,497	Jan. 1	By	Joint Venture (expenses)	1,400
				Mar. 31	By	Joint Venture (interest)	21
				"	By	Joint Venture (profit)	4,076
			<u>5,497</u>				<u>5,497</u>

Amount paid to company has been calculated as under:

	<i>Rs.</i>
Amount payable for 500 shares @ Rs. 25	= 12,500
Less: Underwriting commission @ 4% on Rs. 2,50,000, the issue price of shares @ Rs. 25 per share	= <u>10,000</u>

	=	<u>2,500</u>
<i>Interests payable to P</i>		
On Rs. 1,400 for 3 months @ 6% per annum	=	21
= Rs. $\frac{1,400 \times 6 \times 3}{100 \times 12}$ = Rs. 21		
<i>Interest payable by Q</i>		
On Rs. 9,600 for 1 months @ 6% per annum	=	48
Less : On Rs. 2,500 for 2 months @ 6% per annum	=	<u>25</u>
Net Amount	=	<u>23</u>

Alternative Solution:

Memorandum Joint Venture Account

2007		Rs.	2007		Rs.
Jan. 1	To P (expenses)	1,400	Mar. 1	By Q	9,600
Feb. 1	To Q (payment of company)	2,500		(sale of 400 shares)	
Mar. 31	To P (interest)	21	Mar. 31	By Q	2,450
"	To Profit on Venture:			(sale of 100 shares)	
	P	4,076		By Q (interest)	23
	Q	4,076			
		<u>12,073</u>			<u>12,073</u>

**In P's Ledger
Joint Venture with Q Account**

2007		Rs.	2007		Rs.
Jan. 1	To Cash	1,400	Mar. 31	By Cash	5,497
Mar. 31	To Interest	21			
"	To Profit and Loss A/c	4,076			
		<u>5,497</u>			<u>5,497</u>

**In Q's Ledger
Joint Venture with P Account**

2007		Rs.	2007		Rs.
Feb. 1	To Cash	2,500	Mar. 1	By Cash	9,600
Mar. 31	To Profit & Loss A/c	4,076	Mar. 31	By Cash	2,450
"	To Cash	5,497	"	By Interest	23
		<u>12,073</u>			<u>12,073</u>

Illustration 9

X and Y entered into a joint venture involving the buying and selling of old railway material. The profit and loss was to be shared equally. The cost of the material purchased was Rs. 85,000 which was paid by X who drew a bill on Y at two months demand for 60,000. The bill was discounted by X at a cost of Rs. 480. The transaction relating to the venture was (a) X paid Rs. 600 for carriage, Rs. 1,000 for commission on sales and Rs. 400 travelling expenses, (b) Y paid Rs. 200 travelling expenses and Rs. 300 sundry expenses; (c) sales made by X amounted to Rs. 40,000 and sales made by Y were Rs. 60,000. Goods costing Rs. 2,000 and Rs. 3,000 (being unsold stock) were retained by X and Y respectively and these were charged to them at prices to show the same rate of gross profit that made on total sales (excluding these

sales). X was credited with a sum of Rs. 800 to cover the cost of warehousing and insurance. The expense in connection with the bill were to be treated as a charge against the venture.

You are required to:

- (a) show the account in the books of each party to record his own transactions, and
- (b) prepare a memorandum joint venture account.

Solution:

In the books of X Joint Venture with Y Account			
Dr.			Cr.
	Rs.		Rs.
To Bank (Material purchased)	85,000	By Bill Receivable A/c	60,000
To Discount on Bills	480	By Bank (sale proceeds)	40,000
To Bank:		By Purchase (Note)	2,500
Carriage	600		
Commission	1,000		
Travelling	<u>400</u>		
	2,000		
To Warehousing and insurance expenses	800		
To Profit and Loss A/c (Share of Profit)	8,735		
To Balance c/d	5,485		
	<u>1,02,500</u>		<u>1,02,500</u>

In the Books of Y Joint Venture with X Account			
Dr.			Cr.
	Rs.		Rs.
To Bills Payable A/c	60,000	By Bank (Sales)	60,000
To Bank A/c		By Purchases (Note)	3,750
Travelling	200	By Balance c/d	5,485
Sundry expenses	<u>300</u>	(Amount due)	
	500		
To Profit and Loss A/c (Share of Profit)	8,735		
	<u>69,235</u>		<u>69,235</u>

Memorandum Joint Venture Account			
	Rs.		Rs.
To X: Materials Purchased	85,000	By X: Sale Proceeds	40,000

Discount Charge	480	Goods taken over	2,500
Carriage	600	By Y: Sale Proceeds	60,000
Commission	1,000	Goods take over	3,750
Travelling Expenses	400		
Warehousing and Insurance	800		
To Y: Travelling	200		
Sundry Expenses	300		
To X: (Shares of Profit)	8,735		
To Y: (Share of Profit)	8,735		
	<u>1,06,250</u>		<u>1,06,250</u>

Working Note :

Calculation of Gross Profit and Sales

	Rs.
Goods purchased	85,000
Less : Unsold goods (Rs. 2,000 + 3,000)	5,000
Cost of goods sold	<u>80,000</u>
Sales	<u>1,00,000</u>
Less : Cost of goods sold	80,000
Profit	<u>20,000</u>

$$\text{Rate of gross profit on cost} = \text{Rs. } \frac{20,000}{80,000} \times 100 = 25\%$$

$$\text{Unsold stock taken by X} = \text{Rs. } 2,000 + 25\% = \text{Rs. } 2,500$$

$$\text{Unsold stock taken by Y} = \text{Rs. } 3,000 + 25\% = \text{Rs. } 3,750$$

(ii) When Separate Set of Books is Maintained:

Under this method, joint venture is treated as a separate business entity and separate account books and cash book, journal, ledger, etc. are maintained. Usually the following accounts are maintained under this method:

- Joint Venture Account** : It is in fact a Trading and Profit and Loss Account for the venture showing purchase of goods, expenses, sale of goods etc. Balance of this account will show profit or loss of business and is distributed between co-venturers.
- Joint Bank Account** : It is a separate bank account opened in the joint names showing receipts and payment of cash.
- Personal Accounts of Co-venturers** : It is the capital accounts of the co-venturers showing, investment, entitlements, receipts and drawing by the co-venturers.

The accounting procedure is explained as follows:

A Joint Bank Account is opened by the contribution from the co-venturers, debit being given to Joint Bank Account and Co-venturers' (Capital) Accounts are credited. When expenses are incurred, Joint Venture Accounts is debited against Joint Bank Account if paid therefrom or against Venturers' (Capital) Accounts if paid by them personally. On goods being sold, Joint Bank Account is debited and Joint Venture Account is credited in case the proceeds are paid into the bank. If the sale proceeds are taken over by any venturer, his Capital Account is debited and Joint Venture Account is credited. At the close of the venture unsold goods may be taken over by

a venturer at an agreed value for which the Venturer's Capital Account is debited and the Joint Venture Accounts is credited. If any commission or interest is payable to co-ventures, then Joint Venture Account is debited and Co-venturers' (Capital) Accounts are credited. If it is desired to make an interim settlement until all the goods are sold, the value of unsold stock may be shown by way of balance on the credit side of Joint Venture Account. The balance in Joint Venture Account will now represent profit or loss on the venture which is transferred to Venturers' (Capital) Accounts in the agreed profit sharing ratio. After closing the Joint Venture Account, the balance of the Joint Bank Account is paid out to the co-venturers, each receiving the balance of his Capital Account.

Entries are made on the following lines:

- (i) When funds are contributed and put in joint bank

Joint Bank Account	Dr.	
To Co-venturers		With sums contributed

- (ii) On payment out of joint bank for the joint venture

Joint Venture Account	Dr.
To Joint Bank Account	

- (iii) For materials etc., supplied by a participant

Joint Venture Account	Dr.
To Account of the party supplying the material (by name)	

- (iv) For sale proceeds with Joint Bank

Joint Bank Account	Dr.
To Joint Venture Account	

- (v) If the sale proceeds are received by a participant

Account of the party received payment (by name)	Dr.
To Joint Venture Account	

If some goods are taken up by a party, then also the above mentioned entry will be passed, namely that of debiting the party receiving the goods and crediting Joint Venture Account.

- (vi) To transfer the profit on joint venture

Joint Venture Account	Dr.
To Co-venturers (by name)	

The abovementioned entry is reversed if the joint venture results in a loss.

- (vii) For settlement of accounts

Co-venturers (by name)	Dr.
To Joint Bank	

If the account of a co-venturer shows a debit balance, the abovementioned entry is reversed for him.

Illustration 10 :

Verma and Manik both Building Contractors, undertook a joint venture involving the construction of a house building. The Joint Bank Account was opened in which Verma deposited Rs. 1,00,000 and Manik deposited Rs. 50,000. The contract amount was Rs. 5,00,000. The result of joint venture was to be shared by Verma 2/3rd and Manik 1/3rd. The details of the transaction were as under:

	Rs.
Salaries	16,000

Wages Paid	92,000
Building materials purchased	2,20,000
Material supplied by Verma	18,000
Materials supplied by Manik	16,000
Architect's fees	14,000
Cartage	24,000
Concrete mixer plant purchased	50,000

The stock of the building materials on the completion of the contract, valued at Rs. 22,000 was taken over by Verma. Concrete mixer plant was sold out for Rs. 40,000. Mr. Verma was to pay Rs. 24,000 per annum against establishment expenses, to be charged to the Joint Venture Account. The contract lasted for 8 months.

Prepare a Joint Venture Account, Joint Bank Account and Accounts of Verma and Manik.

Solution:

Joint Venture Account

Dr.				Cr.
	Rs.	Rs.		Rs.
To Joint Bank:			By Joint Bank	5,00,000
Salaries	16,000		(contract price)	
Wages	92,000		By Verma	22,000
Building			(building material	
Materials	2,20,000		taken over)	
Architect's fees	14,000		By Joint Bank	40,000
Cartage	24,000		(sale of concrete mixer)	
Concrete mixer	<u>50,000</u>	4,16,000		
	Rs.	Rs.		Rs.
To Verma-(materials				
supplied)		18,000		
To Verma-Establishment		16,000		
To Manik (material supplied)		16,000		
To Profit to:				
Verma	64,000			
Manik	<u>32,000</u>	96,000		
		<u>5,62,000</u>		<u>5,62,000</u>

Joint Bank Account

	Rs.		Rs.
To Verma	1,00,000	By Joint Venture	4,16,000
To Manik	50,000	(materials and expenses)	
To Joint Venture		By Verma	1,76,000
(contract price)	5,00,000	By Manik	98,000
To Joint Venture (sale			
of concrete mixer)	<u>40,000</u>		
	<u>6,90,000</u>		<u>6,90,000</u>

Co-Venturers Account

Verma	Manik	Verma	Manik
Rs.	Rs.	Rs.	Rs.

To Joint Venture A/c	22,000	—	By Joint Bank	1,00,000	50,000
To Joint Bank	1,76,000	98,000	By Joint Venture	34,000	16,000
			By Joint Venture		
			(profit)	<u>64,000</u>	<u>32,000</u>
	<u>1,98,000</u>	<u>98,000</u>		<u>1,98,000</u>	<u>98,000</u>

Illustration 11 :

Das and Gupta entered into a joint venture to construct a building of a new company. Profit and loss were to be shared in the ratio of 3:2. Das invested Rs. 2,00,000 and Gupta Rs. 1,00,000. The money was deposited to a joint bank account with arrangement of overdraft of Rs. 2,00,000. Das also supplied materials valued Rs. 35,000 and Gupta paid the architects fees of Rs. 15,000. Gupta also supplied a machine valued Rs. 25,000. Building materials valued Rs. 4,00,000 and wages Rs. 1,00,000 were met from the joint bank account.

On completion of the construction the company paid Rs. 8,00,000 out of which Rs. 4,00,000 in cash (deposited into joint bank account) and the balance of Rs. 4,00,000 in fully paid shares of Rs.10 each. These shares were sold at Rs. 9.50 each and proceeds taken by Das and Gupta in the ratio of 3:1. The machine supplied by Gupta was taken by him at an agreed value of Rs.15,000. Bank charged interest Rs. 1,000 for the overdraft.

Prepare necessary ledger accounts.

Solution:

Joint Venture Account					
<i>Dr.</i>			<i>Cr.</i>		
	<i>Rs.</i>			<i>Rs.</i>	
To Co-venturers		By New Company A/c	8,00,000		
Das (Materials)	35,000	By Co-venturer A/c			
Gupta (Architects fees)	15,000	Gupta (Machine taken over)	15,000		
Gupta (machine supplied)	25,000				
To Joint Bank A/c					
Building materials	4,00,000				
Wages	1,00,000				
To Shares in New					
Company A/c	20,000				
To Interest on Overdraft	1,000				
To Co-venturers A/c (profit)					
Das (3/5)	1,31,400				
Gupta (2/5)	87,600				
	<u>8, 15,000</u>			<u>8, 15,000</u>	

Joint Bank Account					
<i>Dr.</i>			<i>Cr.</i>		
	<i>Rs.</i>			<i>Rs.</i>	
To Co-venturers A/c		By Joint Venture A/c			
Das	2,00,000	Materials	4,00,000		
Gupta	1,00,000	Wages	1,00,000		
To Bank Loan A/c (O/D)	2,00,000	By Interest on Overdraft	1,000		
To New Company A/c	4,00,000	By Bank Loan (O/D repaid)	2,00,000		
		By Co-venturers A/c			
		Das	81,400		

				Gupta	1,17,600
				<u>9,00,000</u>	<u>9,00,000</u>
Co-venturers Account					
	<i>Das</i>	<i>Gupta</i>		<i>Das</i>	<i>Gupta</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
To Shares in New Company A/c	2,85,000	95,000	By Joint Venture Bank A/c	2,00,000	1,00,000
To Joint Bank A/c	81,400	1,17,600	By Joint Venture A/c	35,000	15,000
To Joint Venture A/c	—	15,000	By Joint Venture A/c	—	25,000
	<i>Das</i>	<i>Gupta</i>		<i>Das</i>	<i>Gupta</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
			By Joint Venture A/c	1,31,400	87,600
	<u>3,66,400</u>	<u>2,27,600</u>		<u>3,66,400</u>	<u>2,27,600</u>
Shares in New Company Account					
	<i>Rs.</i>			<i>Rs.</i>	
To New Company A/c	4, 00,000	By Co-venturers A/c (Rs. 2,85,000 + Rs. 95,000)		3, 80,000	
		By Joint Venture A/c (Loss on Shares)		20,000	
	<u>4, 00,000</u>			<u>4, 00,000</u>	
New Company Account					
	<i>Rs.</i>			<i>Rs.</i>	
To Joint Venture A/c	8, 00,000	By Joint Bank A/c		4, 00,000	
		By Shares in New Company A/c		4,00,000	
<u>8,00,000</u>		<u>8,00,000</u>			

SELF-TEST QUESTIONS

1. What do you understand by 'Consignment' ?
2. What is an account sales ? How does it differ from invoice ?
3. What is pro-forma invoice ? How does it differ from invoice ?
4. How is stock lying with consignee evaluated ?
5. What is the relationship between a consignor and consignee ?
6. What is normal loss ? How is it treated in books of account of the consignor?
7. What is abnormal loss ? How is it treated ?
8. Can normal loss and abnormal loss take place simultaneously?
9. What is *del credere* commission? Why is it allowed?

10. State which of the following statements are false:

- (i) Normal loss takes places in case of all the goods.
- (ii) Normal loss is natural and unavoidable.
- (iii) Abnormal loss is accidental and occurs due to bad luck, mischief or carelessness.
- (iv) As soon as goods are sent to the consignee, consignee becomes liable to pay for them.
- (v) When del credere commission is allowed to the consignee, bad debts have to be borne by the consignee and not by the consignor.
- (vi) Consignee will pass a journal entry in his books at the time of receiving goods from consignor.
- (vii) Consignee will treat the consignor as creditor at the time of receiving goods.

[Ans. : (i), (iv) (vi) and (vii) are false].

11. How will you treat bad debts when;

- (i) Consignee gets del credere commission
- (ii) Consignee does not get del credere commission.

12. Distinguish between sale and consignment.

13. What do you understand by 'Joint Venture'?

14. State whether the following statements are true or false.

- (i) Joint Venture is in the nature of the partnership.
- (ii) The co-venturers are always sharing profits and losses equally.
- (iii) The number of co-venturers in a joint venture is limited to two.
- (iv) The relationship between co-venturers is that of principal and agent.

[Ans. : Statement (i) is true]

15. P sent 200 bicycles, each costing Rs. 1,500 each to B to be sold at his risk. B was to get, for his services, a commission at the rate of Rs. 80 per bicycle and was to be reimbursed for expenses. B spent Rs. 2,000 on freight and Rs. 2,400 for salesmen's salaries, godown rent, etc.

B sold 160 bicycles @ Rs. 2,200 each and settles his account with P.

Prepare the Consignment Account in P's books.

16. B of Delhi sent a consignment to his agent D of Agra. The invoice price of goods was Rs. 20,000 which was 25% above cost. On receiving the goods, D accepted a 3 month's draft for Rs. 10,000 which was discounted by B @6%. B also spent the following sums:

On freight and cartage	Rs. 500
On godown, insurance and rent	Rs. 300

Fourth-fifth of the goods was sold for Rs. 17,400. D is entitled to a commission of 10% on the invoice price plus 1/5 of any profit (finally remaining) that B might make.

Prepare accounts in the block of B with memorandum columns.

17. Dimple sends goods on consignment to Jaya. The terms are that Jaya will receive 10% commission on the invoice price (which is cost plus 25%) and 20% of any price realised above the invoice price. Jaya will meet his expenses himself, goods to be sent by rail and freight paid.

Dimple sent goods, whose cost was Rs. 1,60,000 spent Rs. 20,000 on freight, forwarding,

etc. Jaya accepted a bill for Rs. 1,60,000 immediately on receiving the consignment. His expense were Rs. 2,500 as rent and 1,500 as insurance. Jaya sold $\frac{3}{4}$ of the goods for Rs. 2,25,000. Part of the sales were on credit and one customer fails to pay Rs. 5,000.

Give Consignment Account and Jaya's Account the books of Dimple and important Ledger Accounts in the books of Jaya.

18. Shashi of Bombay sent a consignment of goods to Punnu of Delhi on the basis that Punnu was to affect sales on behalf of Shashi and receive a commission of 20% of the selling price. Punnu was to be responsible for all the expenses at his end, but the goods were to be forwarded F.O.R. Delhi. The commission was considered to include del credere commission also.

Shashi sent the goods costing Rs. 2, 40,000 at an invoice price of Rs. 3, 00,000. He spent Rs. 5,000 on packings and forwarding. On receiving the goods Punnu accepted Shashi's draft for Rs. 2, 00,000 and paid the following expenses:

Rs.

Freight (Bombay-Delhi)	15,000
Godown rent	5,000
Insurance (Godown)	2,000

He sold $\frac{4}{5}$ th of the goods for Rs. 3, 50,000

There was a bad debts of Rs. 10,000

Give journal entries in the books of both the parties and prepare important ledger accounts.

19. Pai of Madras is an agent for sewing machines manufactured by Mehta in Delhi. A machine costs Rs. 1,500, the invoice price is Rs. 2,000. Pai is entitled to a commission of 15% on this plus 40% on the excess realised over Rs. 2,000 and he is also responsible for expenses incurred by him.

Mehta dispatched 200 machines in January, 2007 drawing on Pai for Rs. 2,00,000 at 3 months. Pai accepted the draft. Expenses paid by Pai were:

Freight	2,500
Storage	800
Insurance	600

At the end of March, 2007 Pai reported that he had sold 150 machines at an average price of Rs. 2,200. It was agreed then that Pai would take over the remaining machines on his own account at landed cost plus 20%

Prepare the consignment account in the books of Mehta.

20. Veena purchased 1,000 pieces of sarees @ Rs. 1,000 per piece, out of these sarees she sent 600 on consignment to Vani Traders of Jalgaon at selling price of Rs. 1200 per saree. Veena paid Rs. 6,000 for packing and freight. Vani traders sold 500 sarees @ Rs. 1250 per piece and incurred Rs. 2000 for selling expense and remitted Rs. 5,50,000 on account to Veena. Vani Traders are entitled to a commission of 5% on total sales plus a further 20% commission on any surplus realised over Rs. 1,200 per saree. 300 sarees were sold by Veena herself @ Rs. 1,300 per saree. Owing to fall in market price, the unsold sarees are to be valued at 10% less. Prepare the consignment account and trading account in the books of Veena and her account in his book of Vani.
21. P and Q enter into a Joint Venture. P supplies goods worth Rs. 60,000 and spends Rs. 1,000 on various expenses. Q sells the entire lot for Rs. 73,500 meeting selling expenses amounting to Rs. 1,800. Q remits to P the amount due.

Record the above mentioned transactions in the books of both the parties.

[Ans.: Profit Rs. 10,700]

22. In a Joint Venture A contributes Rs. 50,000 and B contributes Rs. 1,00,000. Goods are purchased for Rs. 1,12,000. Expenses amount to Rs. 7,500. Sales amount to Rs. 1,30,500. The remaining goods were taken up by B at an agreed price of Rs. 5,000. A and B share profit and losses in the ratio of 1:2 respectively. Accounts are duly settled.

Record transactions in the separate set of books maintained for Joint Venture.

[Ans.: Profit Rs. 16,000]

23. Ram & Shyam entered into a joint venture sharing 2/5th and 3/5th. Ram is to purchase Timber in Madhya Pradesh and forward it to Shyam in Delhi. Ram purchased timber worth Rs. 1,00,000 and paid Rs. 10,000 as expenses. Shyam received the consignment and immediately accepted Ram's draft for Rs. 80,000. Ram got it discounted for Rs. 78,500. Shyam disposes of the timber for Rs. 1,60,000. He had to spend Rs. 3,500 for fire insurance and Rs. 3,000 for rent. Under the agreement he is entitled to a commission of 5% sales.

Give journal entries and ledger accounts in the books of both the parties,

[Ans. : Profit on J.V. — Ram — 13,600 Shyam — 20,400]

24. P & Q, collectors of and dealers in old coins, entered joint venture in purchasing and selling valuable collection of coins just come in the market. The profits and losses of venture are to be shared equally.

P attended the auction sale in Bombay on 1st March, 2007 and purchased the collection for Rs. 1,80,000. He added rare coins from his own stock valued, as agreed with Q, at Rs. 42,000 and dispatched the whole consignment to Q in Calcutta paying Rs. 2,160 for insurance and Rs. 6,000 for packing and freight charges. Q sold the consignment on 1st June, 2007 for Rs. 3,30,000 and rendered a statement to P, in which were shown the following expenses incurred by Q:

Advertising	—	6,000
Carriage	—	3,800
Misc. expenses	—	5,200

Q sent a cheque for the amount due to P. Calculate the amount of the cheque and show how the transaction would appear in P's books where all the accounts of joint venture are kept.

[Ans. : Profit Rs. P — 42,420 Q — 42,420]

Suggested Readings :

- (1) *M.C. Shukla, T.S. Grewal & S.C. Gupta* — Advanced Accounts - Vol. 1
 - (2) *J.R. Monga* — Advanced Financial Accounting
 - (3) *S.N. Maheshwari* — Financial Accounting
 - (4) *Ashok Sehgal & Deepak Sehgal* — Financial Accounting
 - (5) *R. L Gupta & V.K Gupta* — Financial Accounting
-

STUDY XI

PARTNERSHIP ACCOUNTS

1. MEANING OF PARTNERSHIP

Partnership is defined in Section 4 of the Indian Partnership Act, 1932 as “the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all”. Persons among whom such a relationship exists are individually called partners and they are collectively known as a firm. To constitute a partnership, there must be a contract and for a contract, at least two persons are required. The Partnership Act does not lay down any maximum number of partners. But according to section 11 of the Companies Act, a partnership for a banking business must not have more than ten partners and that for any other business it must not have more than twenty partners. Further, there must be an agreement among the partners to share the profit (including negative profits, i.e., losses) of a business. The term ‘business’, however, is used here in its widest sense and includes profession and vocation also. For example, the jobs of medical practitioners or lawyers are not called business but there can be a partnership between two doctors or lawyers. Finally, the business must be carried on by all the partners or any one or some of them on behalf for all the partners. Consequently in partnership, there is a mutual agency among the partners and in the ordinary course of business acts of one partner are considered to be the acts of the firm. The following features must exist in order to constitute a partnership:

- (i) There must be an agreement entered into by all the persons concerned;
- (ii) There must be a ‘business’ and for this purpose business would include any trade, profession or occupation;
- (iii) The business must be carried on for the purpose of earning profits which would be divided among the partners;
- (iv) The business must be carried on by some or all of the partners for the benefit of all of them.

Persons who have entered into partnership with one another are individually known as ‘partners’ and collectively a ‘firm’. The name under which the business is carried on is called the ‘firm’s name’. In other words a firm is a collection of the partners. The assets of the firm are joint property of the partners and the partners are personally liable for all liabilities of the firm.

2. PARTNERSHIP DEED

A contract for partnership need not necessarily be in writing although it is advisable to reduce it in writing to minimise the disputes among the partners. But when the contract is put in black and white, the written contract is called a partnership deed. It is a legal document signed by all the partners and contains the following:

The name of the partners; name of the firm; nature of the business to be carried on by the firm; the powers of the partners; when termination is certain, the term of duration of partnership; the amount of capital to be contributed by each partner, the restrictions on working of each partner; methods of division of profits or losses; salary; commission, interest on capital etc. payable to the partners; interest on drawings to be charged on withdrawals; interest on loan payable to a partner; valuation of goodwill when there is a change in the constitution of the firm; methods of accounting and the arbitration clause, etc.

If there is no partnership deed or if there is no provision in it indicating a contrary intention,

the following provisions of the Partnership Act, apply.

- (i) Every partner has a right to take part in the conduct of the business of the firm and also the right of free access to all records, books and accounts of the firm.
- (ii) Partners share profits and losses equally. It is so, even when partners contribute capital unequally.
- (iii) Partners are not entitled to any interest on capital contributed by them nor can they claim any salary for the work done by them for the firm. In case a partnership deed provides for payment of interest on capital or salary, it is payable only if there is a profit.
- (iv) On amounts advanced by a partner to the firm in excess of his agreed share of capital, the partner is entitled to receive interest on such excess at the rate of 6% per annum.

3. DIFFERENCE BETWEEN PARTNERSHIP AND JOINT VENTURE

The following are the points of distinction between Partnership and Joint Venture:

<i>Partnership</i>	<i>Joint Venture</i>
It is not limited to a specific venture	It is limited to a specific venture
It is a continuing profit seeking enterprise	It is a terminable profit-seeking venture
It is carried on under firm's name	There is no common firm's name in joint venture
Persons carrying on partnership business are called partners	Parties are called co-venturers
Profit or loss is ascertained on an annual basis.	Profit or loss is ascertained after the end of the specific venture
Partnership firms are governed by Indian Partnership Act, 1932.	There is no specific Act for joint ventures.
The doctrine of implied authority is applicable to partners.	The doctrine of implied authority is not applicable to co-venturers.

4. CAPITAL ACCOUNTS – FIXED AND FLUCTUATING

There are only a few points of difference between the accounts of a partnership firm and those of a sole proprietorship concern. One difference is that in a sole proprietorship concern there is only one capital account, whereas, in the firm's ledger as many capital accounts as there are partners in the firm (unless some partner is not required to contribute capital at all). Amount contributed by a partner whether in cash or in the form of some other asset or assets is credited to his capital account. Unless agreed otherwise among the partners, no part of the capital is to be withdrawn during the life time of partnership. However, profits can be withdrawn. By implication, losses will have to be made good.

If a partner advances to the firm a sum over and above the amount of capital required to be contributed by him under the partnership contract, the amount is credited to a loan account opened in his name. In the event of dissolution of partnership, a partner is entitled to receive the amount of loan advanced by him in priority to repayment of capital to the partners. However, if capital is insufficient to meet losses on dissolution, the amount of the loan can be used to meet

losses.

The capital account of a partner may be either a Fixed Capital Account or a Fluctuating Capital Account.

Fixed Capital Account : Under Fixed Capital method there will be two accounts for each partner, i.e. (i) Partners' Capital Account – recording only capital of the partner and (ii) Partners' Current Account – recording the transactions relating to drawings, interest on capital, commission, salary, share of profit or loss, etc. Under this method, capital accounts are not touched at all and debits and credits for interest on capital, interest on drawings, profits, losses, drawings, etc., are made in separate accounts called current accounts or drawing accounts. Capital account is credited only when fresh (or further) capital is introduced or debited when capital is withdrawn. If there is no addition or withdrawal of capital during the year, the capital account does not change and it remains fixed thorough out the year. Sometimes there may be current accounts as well as drawings accounts – the later accounts being used to record only the withdrawals made by partners; drawing accounts in such a case are transferred to the respective current accounts at the end of the year. Such drawing accounts are maintained when drawings are irregular and extensive to facilitate calculation of interest on drawings.

Fluctuating Capital Account : Just as in a sole proprietorship concern, in partnership also, profits or losses, drawings, interest on capital, interest on drawings, salary (to partner), commission, additional capital introduced, etc., may all be recorded in the capital accounts. Such capital accounts are called Fluctuating Capital Accounts because the balances of these accounts continue to fluctuate due to various debits and credits. Under this method there is no need to maintain respective current accounts because all transactions passing through current accounts are passed through capital accounts.

The fixed capital and fluctuating capital methods may be distinguished as follows:

<i>Fixed Capital Method</i>	<i>Fluctuating Capital Method</i>
1. Two accounts are maintained, i.e. capital account and current account	Only one account i.e. capital account is maintained.
<i>Fixed Capital Method</i>	<i>Fluctuating Capital Method</i>
2. Balance in capital account remains the same except when capital is introduced or capital is withdrawn.	The balance in capital account changes every year because of profits/losses, drawings, interest on capital, interest on drawings, etc.
3. All adjustments in respect of profit, loss, drawings, interest on capital, interest on drawings, salary, commission, etc. are made in the current account.	All adjustments in respect of profit, loss, drawings, interest on capital, interest on drawings, salary, commission, etc. are made in the capital account.
4. The capital account will always have plus or credit balance while the current account may have debit (negative) balance.	Fluctuating capital may sometimes show a debit (negative) balance.

Final accounts of a partnership firm are prepared in the same way in which they are prepared for a sole proprietorship concern except that the profits in the former case have to be distributed among the various partners according to the terms of the partnership contract and the amount of profit may be arrived at after making adjustments for interest on capital, interest on drawings, salaries to partners, etc.

5. PROFIT AND LOSS APPROPRIATION ACCOUNT

As against the proprietorship business, the profits of the partnership firm are divided among

partners in a given ratio. The profit has to be divided between the partners in the profit sharing ratio after making necessary adjustments stated in the partnership deed such as interest on capitals, interest on drawings, salaries or/commission to partners, etc. For this purpose an additional account is prepared, known as Profit and Loss Appropriation Account in which the net profit is transferred from Profit and Loss Account and necessary adjustments are made therein before the profit is divided between the partners. A pro-forma of profit and Loss account is as follows:

Profit and Loss Appropriation Account			
<i>Dr.</i>			<i>Cr.</i>
To Interest on Capital X's Capital/Current A/c Y's Capital/Current A/c To Partners' Salary X's Capital/Current A/c Y's Capital/Current A/c To Partners' Commission X's Capital/Current A/c Y's Capital/Current A/c To Transfer to Reserve To Profit transferred to: X's Capital/Current A/c Y's Capital/Current A/c	<i>Rs.</i>	By Profit and Loss Account (profit of the current year) By Interest on drawings: X's Capital/Current A/c Y's Capital/Current A/c	<i>Rs.</i>

6. INTEREST ON CAPITAL

Where the profit sharing ratio is different from the ratio of capitals contributed by the partners, interest on capitals may be allowed to partners and charged against the profits of the firm to make the distribution of profits equitable. Interest on capital being an appropriation of profits, should be chargeable only out of the profits available. In case of loss, no interest on capital is provided. But in case of insufficient profits, i.e. net profit is less than the amount of interest on capital, the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only. Interest on capitals may be charged after adjusting therein debit balances in the Current Accounts if partnership deed provides for such an adjustment otherwise interest is mostly calculated on the capitals at the commencement of the year. Where fresh capital has been introduced during the course of the year, interest is also allowed on this additional amount for the period for which the amount has been in business. Journal entry for interest on capital will be:

Profit and Loss Appropriation A/c Dr.
 To Partner's Capital/Current account

7. INTEREST ON DRAWINGS

Just as interest is allowed on capitals, interest may be charged on drawings made by partners to make distribution of profit more equitable. Interest on drawings has to be charged on different amounts withdrawn for different periods. Students should remember that where a partner draws a fixed sum at the end of each month, the interest on his drawings for the year will be equal to the interest on his total drawings for a period of $5\frac{1}{2}$ months, if he withdraws the fixed amount in the middle of each month, interest will have to be calculated on his total drawings for a period of six months and if he withdraws the amount at the beginning of each month, interest on total drawings for the period of $6\frac{1}{2}$ months. Journal entry for interest on drawing will be:

Partner's Capital/Current A/c Dr.
 To Profit and Loss Appropriation A/c

8. SALARY TO PARTNERS

If in a firm there are some active partners and some sleeping partners, the active partners may be allowed salary for the work. The salary paid to partners are debited to Profit and Loss

Appropriation Account and credited to the Capital/Current Account of the partners concerned. The payment of salaries is regarded as a distribution of part of the profit of the firm. Thus the amount of profit is reduced before it is divided in the agreed profit sharing ratio. The accounting treatment is same when a partner is paid commission or bonus. Journal entry for salary to partners will be as follows:

Profit and Loss Appropriation A/c	Dr.
To Partner's Capital/Current A/c	

Illustration 1:

On 1st April, 2006 P and Q started business in partnership agreeing to share profits and losses equally, P contributed Rs. 30,000 while Q contributed Rs. 20,000 by way of capital. It was agreed that interest be allowed on capital @6% per annum and charged on drawing @ 8% per annum. P withdrew Rs. 200 at the end of every months whereas Q withdrew Rs. 450 in the middle of every month.

Profits before the above noted adjustments for the year ended 31st March, 2007 amounted to Rs. 8,970. Show the necessary ledger accounts assuming:

- (a) capital accounts are fluctuating
- (b) capital accounts are fixed.

Solution:

Working Notes:

$$\begin{aligned}
 \text{Interest on P's Capital} &= \text{Rs. } \frac{30,000 \times 6}{100} \\
 &= \text{Rs. } 1,800 \\
 \text{Interest on Q's Capital} &= \text{Rs. } \frac{20,000 \times 6}{100} \\
 &= \text{Rs. } 1,200 \\
 \text{Total drawing by P} &= \text{Rs. } 200 \times 12 \\
 &= \text{Rs. } 2,400 \\
 \text{Total drawings Q} &= \text{Rs. } 450 \times 12 = \text{Rs. } 5,400 \\
 \text{Interests on P's drawings} &= \text{Rs. } \frac{2,400 \times 11 \times 8}{2 \times 12 \times 100} \\
 &= \text{Rs. } 88 \\
 \text{Interest on Q's drawings} &= \text{Rs. } \frac{5,400 \times 6 \times 8}{12 \times 100} \\
 &= \text{Rs. } 216
 \end{aligned}$$

(a) When capital accounts are fluctuating:

Profits and Loss (Appropriation) Account			
Dr.		Cr.	
	Rs.		Rs.
To Interest Capital:		By Balance of profits b/d	8,970
P's Capital A/c	1,800	By Interest on Drawings:	

Q's Capital A/c	1,200	P's Capital A/c	88
To P's Capital Account (1/2 profit)	3,137	Q's Capital A/c	216
To Q's Capital Account (1/2 profit)	3,137		
	<u>9,274</u>		<u>9,274</u>

P's Capital Account

2007				Rs.	2006				Rs.
Mar.	31	To	P's Drawings A/c transfer	2,400	Apr.	1	By	Cash A/c	30,000
"		To	Profits and Loss Appropriation A/c (Interest on Drawings)	88	2007				
					Mar.	31	By	Profits and Loss Appropriation A/c (Interest Capital)	1,800
"		To	Balance c/d	32,449	"	"	By	Profits and Loss Appropriation A/c	<u>3,137</u>
				<u>34,937</u>					<u>34,937</u>
					2007				
					Apr.	1	By	Balance b/d	32,449

Q's Capital Account

2007				Rs.	2006				Rs.
Mar.	31	To	Q's Drawings A/c- Transfer	5,400	Apr.	1	By	Cash	20,000
"		To	Profits and Loss Appropriation A/c (Interest on Drawings)	216	2007				
					Mar.	31	By	Profit and Loss Appropriation A/c (Interest Capital)	1,200
"		To	Balance c/d	18,721	"		By	Profit and Loss Appropriation A/c	<u>3,137</u>
				<u>24,337</u>					<u>24,337</u>
					2007				
					Apr.	1	By	Balance b/d	18,721

(b) When capital accounts are fixed:

Dr.	Profits and Loss (Appropriation) Account		Cr.
	Rs.		Rs.
To Interest Capital:		By Balance of profits b/d	8,970
P's Current A/c	1,800	By Interest on Drawings:	
Q's Current A/c	1,200	P's Current A/c	88
To P's Current A/c		Q's Current A/c	216
(1/2 profit)	3,137		
To Q's Current A/c			
(1/2 profit)	<u>3,137</u>		
	<u>9,274</u>		<u>9,274</u>

P's Capital Account

2007				Rs.	2006				Rs.
Mar.	31	To	Balance c/d	30,000	Apr.	1	By	Cash A/c	30,000

				2007					
				Apr. 1	By	Balance b/d		30,000	
Q's Capital Account									
2007				Rs.	2006				Rs.
Mar. 31	To	Balance c/d		<u>20,000</u>	Apr. 1	By	Cash		<u>20,000</u>
				2007					
				Apr. 1	By	Balance b/d		20,000	

P's Current Account									
2007				Rs.	2007				Rs.
Mar. 31	To	P's Drawings*			Mar. 31	By	Profit and Loss		
		Account-transfer	2,400				Appropriation A/c	1,800	
"	To	Profit and Loss					(Interest on Capital)		
		Appropriation A/c	88		"	By	Profit and Loss		
		(Interest of drawings)					Appropriation A/c		
	To	Balance c/d	<u>2,449</u>				(profit)	<u>3,137</u>	
				<u>4,937</u>					
				2007					
				Apr. 1	By	Balance b/d		2,449	

* It has been assumed that separate Drawings Accounts have also been maintained if separate Drawings Accounts are not maintained, cash withdrawn by partners every month will also appear in current account. P's Current Account will then appear as follows:

P's Current Account									
2006				Rs.	2007				Rs.
Apr. 30	To	Cash	200		Mar. 31	By	Profit and Loss		
May 31	To	Cash	200				Appropriation A/c		
June 30	To	Cash	200				(Interest on Capital)	1,800	
July 31	To	Cash	200			By	Profit and Loss		
Aug. 31	To	Cash	200				Appropriation Account		
Sep. 30	To	Cash	200				(Profit)	3,137	
Oct. 31	To	Cash	200						
Nov. 30	To	Cash	200						
Dec. 31	To	Cash	200						
2007									
Jan. 31	To	Cash	200						
Feb. 28	To	Cash	200						
Mar. 31	To	Cash	200						
Mar. 31	To	Profit and Loss							
		Appropriation A/c	88						
		(Interest on Drawings)							
	To	Balance c/d	<u>2,449</u>						
				<u>4,937</u>					
				2007					
				Apr. 1	By	Balance b/d		2,449	

Q's Current Account									
2007				Rs.	2007				Rs.
Mar. 31	To	Q's Drawings A/c*-	5,400		Mar. 31	By	Profit and Loss		

"	transfer		Appropriation A/c	1,200
	To Profit and Loss		(Interest capital)	
	Appropriation A/c	216	By Profit and Loss	
	(Interest on Drawings)		Appropriation A/c	3,137
			(Profit)	
			By Balance c/d	<u>1,279</u>
		<u>5,616</u>		<u>5,616</u>

2007

Apr. 1 To Balance b/d 1,279

- * *Note:* Prepare Q's Current Account yourself, assuming no separate Drawings Account has been maintained.

9. ADJUSTMENT OF PROFIT

Sometimes, amounts already distributed among the partners as profits or losses for a particular year require to be readjusted after the close of accounts for the year either due to discovery of some mistakes subsequent to the closing of the books or due to revision of certain condition of the partnership contract with retrospective effect. In such a case, the revenue accounts which have already been closed off are not reopened. Amounts already debited or credited to various partners are compared with the amounts which should have been debited or credited and an entry is passed for the difference to adjust the various accounts.

Illustration 2:

On 1st April, 2007 the capital accounts of A, B and C stood at Rs. 30,000, Rs. 20,000 and Rs. 10,000 respectively. They shared profits and losses equally. Profit and Loss account for the year ended 31 March, 2007 revealed a net profit of Rs.12, 000 which was transferred to capital accounts of the partners equally.

It was decided in April 2007 that profits should be distributed equally after allowing interests on capital @ 6% per annum with effect from 1st April, 2006. While going through the books of account for 2006-07 it was discovered that repair charges for A's personal scooter amounting to Rs. 90 had been charged to Repairs Account.

Show the journal entries necessary to adjust the current account of the partners.

Solution:

		Rs.
Profits as already distributed		12,000
Add: Repair charges to be charged to A's Current Account		90
		<u>12,090</u>
Less : Interest on		
	Rs.	
A's Capital	1,800	
B's Capital	1,200	
C's Capital	600	3,600
	<u> </u>	<u> </u>
Net profit after adjustment		8,490
		<u> </u>

Each partner will get Rs. $\frac{8,490}{3}$ = Rs. 2,830

Revised Distribution

	A	B	C
	Rs.	Rs.	Rs.
Net Profit	2,830	2,830	2,830
Interest of Capital	<u>1,800</u>	<u>1,200</u>	<u>600</u>
	4,630	4,030	4,430
Less : Repair charges	<u>90</u>	<u>—</u>	<u>—</u>
	4,540	4,030	3,430
Distribution as already made of Rs. 12,000	<u>4000</u>	<u>4000</u>	<u>4000</u>
Net Adjustment to be made	<u>+540</u>	<u>+30</u>	<u>— 570</u>

Journal Entry

		Rs.	Rs.
C's Current Account	Dr.	570	
To A's Current Account			540
To B's Current Account			30
(Adjustment effected for change on the basis of distribution of profit for 2006-07 and error located in the accounts for 2006-07)			

Illustration 3:

C and D were sharing profits in the ratio of 3:1. Profits as per books for 2006-07 amounted to Rs. 40,000. In April 2007, they agreed to change the profit sharing ratio to 5:3 with retrospective effect from 1st April, 2006. It was found that outstanding expenses of Rs. 4,000 as on 31st March, 2006 and outstanding expenses of Rs. 3,000 as on 31st March, 2007 had not been taken into account while drawing up the final accounts for 2005-06 and 2006-07. Also by mistake interest on drawings had been ignored while preparing the accounts for 2006-07 such interest being Rs. 600 on C's drawings and Rs. 300 on D's drawings.

Pass the necessary journal entries to adjust the capitals of partners.

Solution:

Working Notes:

	C	D
Old ratio	3:1 or 6	2
New Ratio	5	3
D gets 1/8 more		

	C Rs.	D Rs.
Old distribution of Rs. 40,000	30,000 Cr.	10,000 Cr.
New distribution of Rs. 40,000 + Rs. 600 + Rs. 300 or Rs. 40,900 in the ratio of 5 : 3	<u>25,562.50</u> Cr.	<u>15,337.50</u> Cr.
Interest on Drawings	600 Dr.	300 Dr.
	<u>24,962.50</u> (Net) Cr.	<u>15,037.50</u> (Net) Cr.

Difference	5,037.50 Dr.	5,037.50 Cr.
------------	--------------	--------------

Outstanding expenses of Rs. 4,000 as on 31st March, 2006 will be debited to partners' capital accounts in the old ratio (to raise Outstanding Expenses Account) and then will be credited to partners' capital accounts in the new ratio (to write off Outstanding Expenses Account). Outstanding Expenses of Rs. 3,000 will be debited to capital account in the new ratio and credited to Outstanding Expenses Account. In the entry shown below only the net effect has been recorded:

Journal Entries

		<i>Dr.</i>	<i>Cr.</i>
		<i>Rs.</i>	<i>Rs.</i>
C's Capital Account	Dr.	2,375*	
D's Capital Account	Dr.	625*	
To Outstanding Expenses Account			3,000
(Adjustment entry for outstanding expenses of Rs. 4,000 as on 31st March, 2006 and of Rs. 3,000 as on 31st March, 2007)			
C's Capital Account	Dr.	5,037.50	
To D's Capital Account			5,037.50
(Entry to adjust capital accounts on redistribution of profit for 2006-07)			
		<i>C</i>	<i>D</i>
* 31.3.2006 (Ratio 3 : 1)		Dr. 3,000	Dr. 1,000
1.4.2006 (Ratio 5 : 3)		Cr. 2,500	Cr. 1,500
31.3.2007 (Ratio 5 : 3)		<u>Dr. 1,875</u>	<u>Dr. 1,125</u>
		<u>Dr. 2,375</u>	<u>Dr. 625</u>

Note : If capital accounts are fixed, current accounts will be debited and credited instead of capital accounts.

10. GUARANTEE OF PROFIT TO A PARTNER

Sometimes to induce a person to become a partner, a guarantee is given to him by other partners that his share of profits will not be below a certain figure. Usually when such a guarantee is given, it is also agreed that if in a year his share of profit exceeds the minimum limit, he would have to refund the excess in repayment of amount previously credited to him in excess of his normal share of profits. When such an agreement exists, first profits should be divided as if no guarantee has been given. Then, the amount by which the actual share falls short of the guaranteed share should be credited to the partner to whom the guarantee has been given and debited to other partners in their mutual profit sharing ratio. For recoupment of excess in subsequent years, a reverse entry will be passed.

Instead of all the partners, one partner may give the guarantee to a new partner that should the share of profits to the new partner fall below a certain figure; guarantor will make up the difference. In such case, the capital account of the partner in whose favour the guarantee is given will be credited and the capital account of the guarantor partner will be debited for the excess of the guaranteed amount over the actual share of the partner in whose favour guarantee has been given.

There can also be an arrangement that should profit due to the new partner exceed a certain figure, a particular partner, may bear the burden of such excess. It is really a guarantee to the other partners that the share of the new partner will not exceed a stipulated figure.

Illustration 4:

With effect from 1st April, 2006, D, the manager in the firm of A,B, and C who were sharing profits and losses in the ratio of 5:3:2 respectively was admitted as a partner in the firm with 1/11th share of profit. It was agreed that should D' share of profits exceed his remuneration as the manager, A will bear the burden of such an excess. As the manager D was entitled to a salary of Rs. 10,000 p.m. plus a commission of 2% of net profit remaining after charging his salary but before charging his commission.

Profit and Loss Account for the year ended 31st March, 2007 showed a profit of Rs. 22, 00,000. Show how the profit will be distributed among the four partners.

Solution:

The main point is that B and C are not to suffer due to D's becoming a partner. Suppose D is still the manager; then:

	Rs.
Profit as given	22, 00,000
Less: Salary which D would have received	<u>1, 20,000</u>
	20, 80,000
Less: D's commission @ 2% on Rs. 20, 80,000	<u>41,600</u>
Net profit	<u>20,38,400</u>

	A (5/10)	B (3/10)	C (2/10)	D (as Manager)
Distribution	10, 19,200	6, 11,520	4, 07,680	1, 61,600

Under the new arrangement D will receive 1/11th of Rs. 22, 20,000 i.e., Rs. 2,00,000. It means that D will get Rs. 38,400 more than what he would have got as manager. This will be deducted from A's share. Hence, the profit of Rs. 22, 00,000 will be distributed as follows:

A	Rs. 9, 80,800
B	Rs. 6, 11,520
C	Rs. 4, 07,680
D	Rs. 2, 00,000

Illustration 5:

P and S were in partnership sharing profits and losses in the ratio of 7:3 respectively. As a mark of appreciation of the services of their manager Z, they admitted him into partnership on 1st April, 2006 giving him 1/10th share of the future profits; the mutual ratio between P and S remaining unchanged. Before becoming a partner, Z was getting a salary of Rs. 4,000 per month and a commission of 5% on the net profits remaining after charging his salary and commission. It was agreed that any excess over his former remuneration to which Z as a partner becomes entitled will be provided out of P's share of profit.

The net profit for the year ended 31st March, 2007 amounted to Rs. 19, 80,000. Prepare the profit and loss appropriation account for the year ended 31st March 2006 showing the distribution of the profits of the net profits amongst the partners. Show your working notes clearly.

Solution:

In the books of P, S and Z		
Profits and Loss Appropriation Account		
Dr.	for the year ended 31st March,2007	Cr.

Particulars	Rs.	Particulars	Rs.
To Profit transferred to Capital A/c		By Net profit b/d	19, 80,000
P	12, 30,000		
S	5, 52,000		
Z	<u>1, 98,000</u>		
	<u>19, 80,000</u>		<u>19, 80,000</u>

Working Notes:

	Rs.	Rs.	
(1) Z's share – 1/10 of Rs. 19, 80,000		1, 98,000	Less:
Z's share as manager:			
Salary Rs. 4,000 × 12	48,000		
Commission: $\left(\frac{5}{105} \text{ of Rs. } 19,80,000 \right)$	<u>92,000</u>	1, 40,000	
(i.e. Rs. 19,80,00 – 48,000)			
Excess amount chargeable to P		<u>58,000</u>	
(2) When Z acted as manager, divisible profit of the old partner would have been (Rs. 19,80,000 – 1,40,000)		18,40,000	
∴ P's share of profit would have been $\frac{7}{10}$			
of Rs. 18,40,000	12,88,000		
S's share of profits would have been $\frac{3}{10}$			
of Rs. 18,40,000	<u>5,52,000</u>	18,40,000	
(3) When Z becomes a partner, share of profit of each:			
P (Rs. 12,88,000 – Rs. 58,000)		12,30,000	
S		5, 52,000	
Z		<u>1, 98,000</u>	
		<u>19, 80,000</u>	

Alternatively, the final distribution of profit can be arrived at as follows:

Profit and Loss Appropriation Account

	Rs.		Rs.
To Z's Capital A/c (1/10)	1, 98,000	By Net Profit b/d	19, 80,000
To Balance c/d	<u>17, 82,000</u>		
	<u>19, 80,000</u>		<u>19, 80,000</u>
To P's Capital A/c (7/10)	12, 88,000	By Balance c/d	17, 82,000
To S's Capital A/c (3/10)	<u>5, 52,000</u>	By P's Capital A/c	<u>58,000</u>
	<u>18, 40,000</u>		<u>18, 40,000</u>

Final Distribution

		Rs.
P=Rs 12,88,000-Rs.58,000	=	12,30,000
S	=	5,52,000
Z	=	<u>1,98,000</u>
		<u>19,80,000</u>

11. ADMISSION OF NEW PARTNER

A new partner can be admitted with the consent of all existing partner. The various reasons for admission of a new partner may be requirement of more capital, influence or managerial skill, etc. Admission of new partner results in the reconstitution of partnership firm, as a new agreement to carry on the business as a partnership business comes into existence. When a new partner is admitted he is entitled to share in the assets of the firm and in the future profits of the firm. For acquiring the right to share the assets of the firm, he has to contribute capital as may be agreed upon. For his right to share in the future profits of the firm, the new partner is required to bring some amount which is known as goodwill. When a partner is admitted in an existing firm, there is a change in the constitution of partnership resulting which the profit sharing ratio of the existing partners may be revised.

When a new partner is admitted, the amount brought in by him as his capital is credited to a newly opened Capital Account in the name of the new partner. The new partner may contribute to the capital of the firm in the form of assets other than cash also.

From the accounting point of view, the admission of a new partner requires some adjustments in the aspects like, distribution of accumulated profits and reserves, revaluation of assets and liabilities, change in the profit sharing ratio, calculation of sacrificing ratio, adjustment regarding goodwill, adjustment regarding capital, etc.

Illustration 6:

X and Y are carrying on business in partnership. Z is admitted as a new partner who brings in Rs.8, 000 in cash and trade marks and patents valued at Rs. 2,000. Pass the journal entry.

Solution:

Cash	Dr.	8,000	
Patents and Trade Marks	Dr.	2,000	
To Z's Capital Account			10,000
(Capital brought in by Z in the form of cash, patents and trade marks)			

The entry signifies the admission of the partner. However, as stated, before a partner is admitted, a number of adjustments have to be made which are explained in subsequent paragraphs.

12. TREATMENT OF RESERVES ON ADMISSION OF A PARTNER

Reserves created out of profits or balance in Profit and Loss Account at the time of admission of a new partner must be transferred to the capital accounts of the old partners in the old profit sharing ratio. In the examination it must be done even if the question does not specially ask for it. It is done because the new partner is not to get any share of the past accumulated profits and similarly, he is not to bear any part of the past losses. In case, there is no new partner admitted, but the partners agree on a change in the profit sharing ratio, the existing reserves should be credited to the capital accounts in the old profit sharing ratio.

The journal entry will be:

To Old Partners's Capital/Current Account

To Profit and Loss A/c

(To record increase in

the book values of assets and decreases in the book value of liabilities as agreed upon on admission of the new partner).

Revaluation Account
To Old Partners' Capital/Current
Account (individually)

Dr.

(Transfer of profit on revaluation to old partners' capital accounts in their old profit sharing ratio)

OR

Old Partners' Capital/Current
Account (individually)
To Revaluation Account

Dr.

(Transfer of loss on revaluation to old partners' capital accounts in their old profit sharing ratio).

Sometimes, all the partners including the new partner may agree to keep the assets and liabilities at the old values even when they agree to revalue them. In order to record this Memorandum Revaluation Account is opened. It has two parts. In the first part the entries for revaluation of assets and liabilities are made in the usual manner. But no record of revaluation of assets and liabilities is made through the respective ledger accounts. The resultant profit or loss on revaluation in the first part is transferred to the capital accounts of old partners in the old profit sharing ratio. In order to complete the double entry, entries made in the first part is reversed in the second part so that the value of assets and liabilities remain unchanged. The balance in the second part is transferred to the capital accounts of all the partners including new partner in their new profit sharing ratio. If there is a profit, the following entries are passed:

Memorandum Revaluation Account
To Old Partners' Capital/Current
Accounts (individually)

Dr.

(Profit on revaluation transferred to old partners' capital accounts in old profit sharing ratio.)

All the Partners' (including new partners')
Capital Accounts/Current (individually)
To Memorandum Revaluation Account

Dr.

(Transfer of
Memorandum
Revaluation Account to
all the partners'
(including the new
partners') capital
accounts in the new

profit sharing ratio.

If there is a loss on revaluation, the above entries will be reversed.

The following are difference between revaluation account and memorandum revaluation account:

- (i) Revaluation account is prepared to find out the profit or loss on revaluation of assets and liabilities which appear in the new balance sheet at the revalued figures. Memorandum revaluation account is also prepared to record the effect of revaluation of assets and liabilities and recorded at their old figures in the new balance sheet.
- (ii) Memorandum revaluation account has two parts. The profit or loss of first part goes to old partners while the profit or loss of the second part goes to all the partners including the new partner. Revaluation account is not divided in parts.
- (iii) The net result of revaluation of assets and liabilities in the revaluation account is transferred to old partners' capital account in the old profit sharing ratio. In the case of Memorandum revaluation account the first part is used to record the changes in the value of assets and liabilities due to revaluation and in the second part, the effect of the first part is cancelled. The balance of the first part is transferred to old partners' capital account in the old profit sharing ratio while the balance of the second part is transferred to all partners including the new partner in the new profit sharing ratio.

14. CHANGE IN PROFIT SHARING RATIO

When the new profit sharing ratio, is not specially, mentioned but only the share given to the new partner is mentioned, the assumptions is that the old partners among themselves continue to share profits in the same relative ratio in the which they were sharing profits prior to admission of the new partner. In such a case, the share given to the new partner should be deducted from 1 and then the remainder should be divided among the old partners in the old ratio. Suppose, A and B are partners sharing profits and losses in the ratio of 3:2 and they admit C as a new partner giving him 1/5 share in future profits. Then the new ratio will be calculated as follows:

$$\begin{aligned}\text{C's share} &= \frac{1}{5} \\ \text{Remaining share} &= 1 - \frac{1}{5} = \frac{4}{5} \\ \text{A's share} &= \frac{4}{5} \times \frac{3}{5} = \frac{12}{25} \\ \text{B's share} &= \frac{4}{5} \times \frac{2}{5} = \frac{8}{25} \\ \text{C's share} &= \frac{1}{5} = \frac{5}{25}\end{aligned}$$

New ratio for A, B, and C is 12: 8: 5

Sometimes the new partner purchases his share from the other partner in different proportion. Suppose in the above example C purchases 4/25th share from A and 1/25 share from B. Then the new ratio will be calculated as follows:

$$\begin{aligned}\text{A's share} &= \frac{3}{5} - \frac{4}{25} = \frac{15 - 4}{25} = \frac{11}{25} \\ \text{B's share} &= \frac{2}{5} - \frac{1}{25} = \frac{10 - 1}{25} = \frac{9}{25} \\ \text{C's share} &= \frac{4}{25} + \frac{1}{25} = \frac{5}{25}\end{aligned}$$

Hence, the new ratio = 11: 9: 5.

Illustration 8:

On 31st March, 2007 the following was the Balance Sheet of A and B who were equal

partners:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	8,940	Cash in hand	950
General Reserve	10,000	Stock	32,710
A's Capital Account	35,000	Debtors	11,000
B's Capital Account	20,000	Less: Provision for bad debts	<u>220</u> 10,780
		Furniture and Fittings	9,500
		Land and Buildings	20,000
	<u>73,940</u>		<u>73,940</u>

On 1st April 2007, C was admitted as a new partner on the following conditions:

- (i) A, B and C's admission share profits and losses in the ratio 4:3:2
- (ii) Prior to C's admission appreciation of Rs. 15,000 in the value of land and buildings would be recorded and provision for bad debts would be brought upto Rs. 820.
- (iii) C would bring Rs. 20,000 in cash as his capital.

Pass journal entries to record the above mentioned transactions and show the balance sheet of firm immediately after C's admission.

Solution :

Journal Entries

	<i>Dr.</i>	<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>
General Reserve	Dr. 10,000	
To A's Capital Account		5,000
To B's Capital Account		5,000
(Transfer of General Reserve to old partners in old profit sharing ratio)		
Land and Building Account	Dr. 15,000	
To Revaluation Account		15,000
(Appreciation in the value of land and buildings as agreed on admission of C as a new partner).		
Revaluation Account	Dr. 600	
To Provision for Bad Debts		600
(Increase in provision for bad Debts by Rs. 600)		
	<i>Dr.</i>	<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>
Revaluation Account	Dr. 14,400	
To A's Capital Account		7,200

To B's Capital Account 7,200
 (Transfer of net profit on revaluation to old partners capital accounts in old profits sharing ratio)

Cash Account Dr. 20,000 20,000
 To C's Capital Account
 (Cash brought in by C as in his capital)

Balance Sheet of A, B and C as on 1st April, 2007

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	8,940	Cash	20,950
A's Capital Account	47,200	Stock	32,710
B's Capital Account	32,200	Debtors	11,000
C's Capital Account	20,000	Less:	
		Bad Debts	820
		Furniture and Fittings	9,500
		Land and Buildings	35,000
	1,08,340		1,08,340

Revaluation Account

Dr.	Rs.	Cr.	Rs.
To Provision for Bad Debts	600	By Land and Buildings	15,000
To A's Capital Account	7,200		
To B's Capital Account	7,200		
	15,000		15,000

Capital Accounts

	A Rs.	B Rs.	C Rs.		A Rs.	B Rs.	C Rs.
To Balance c/d	47,200	32,200	20,000	By Balance b/d	35,000	20,000	
				By General Reserve	5,000	5,000	
				By Revaluation	7,200	7,200	
				By Cash			20,000
	47,200	32,200	20,000		47,200	32,200	20,000
				By Balance b/d	47,200	32,200	20,000

If the values of assets and liabilities were not to be changed, the following would have been the solution:

Journal Entries

	Dr.	Rs.	Rs.
General Reserve		10,000	
To A's Capital Account			5,000
To B's Capital Account			5,000
(Transfer of General			

Reserve to old partners
in old profit sharing
ratio)

Memorandum Revaluation Account	Dr.	14,400	
To A's Capital Account			7,200
To A's Capital Account			7,200

(Record of profit on
revaluation)

Cash	Dr.	20,000	
To C's Account			20,000

(Cash brought in by C as his capital)

A's Capital Account	Dr.	6,400	
B's Capital Account	Dr.	4,800	
C's Capital Account	Dr.	3,200	
To Memorandum Revaluation Account			14,400

(Transfer of Memorandum Revaluation Account after C's
admission to all the partner's capital accounts in the profit
sharing ratio)

Balance Sheet of A, B and C on 1st April, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	8,940	Cash	20,950
A's Capital account	40,800	Stock	32,710
B's Capital Account	27,400	Debtors	11,000
C's Capital Account	16,800	Less: Provision	
		for Bad Debts	<u>220</u>
		Furniture and Fittings	9,500
		Land and Buildings	20,000
	<u>93,940</u>		<u>93,940</u>

Working Notes:

<i>Dr.</i>	Memorandum Revaluation Account		<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
To A's Capital Account	7,200	By A's Capital account	6,400
To B's Capital Account	7,200	By B's Capital Account	4,800
		By C's Capital Account	3,200
	<u>14,400</u>		<u>14,400</u>

Capital Accounts

<i>Dr.</i>				<i>Cr.</i>		
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
To Memorandum				By Balance b/d	35,000	20,000
Revaluation A/c	6,400	4,800	3,200	By General Reserve	5,000	5,000
To Balance c/d	40,800	27,400	16,800	By M. Revaluation A/c	7,200	
				By Cash A/c		<u>20,000</u>
	<u>47,200</u>	<u>32,200</u>	<u>20,000</u>		<u>47,200</u>	<u>32,200</u>
				By Balance c/d	40,800	27,400
						16,800

15. SACRIFICING RATIO

In partnership business when a partner is admitted into a firm, the old partners have to surrender a portion of their share of profits in favour of the new partner. Thus sacrificing ratio is the difference between old profit sharing ratio and the new profit sharing ratio of the old partners. Goodwill at the time of the admission should always be credited to the capital accounts of the old partners in the sacrificing ratio. In this case sacrifice made by the existing partners may either be in the ratio in which they were sharing profit prior to the admission or in some other ratio. This may be as follows:

- (i) Besides the old ratio of old partners if the new ratio of the incoming partners has been given without mentioning the details of the sacrifice made by the old partners, then the presumption is that the old partners have made sacrifice in the old ratio.
- (ii) Sometimes, the new ratio of all the partners and old ratio of old the partners are given. In that case sacrificing ratio must be calculated by deducting the new share from the old share of the old partners.

For example, if A and B share profits in the ratio of 5:3 and on admission of C the new ratio between A, B and C is agreed upon as 7:5:4 respectively, the ratio of sacrifice will be calculated as follows:

$$\begin{aligned}
 \text{Sacrifice by A} &= \text{As old share} - \text{As new share} &= \frac{5}{8} - \frac{7}{16} = \frac{3}{16} \\
 \text{Sacrifice by B} &= \text{B's old share} - \text{B's new share} &= \frac{3}{8} - \frac{5}{16} = \frac{1}{16} \\
 \text{Hence ratio of sacrifice between A and B} &&= \frac{3}{16} : \frac{1}{16} \text{ or } 3 : 1
 \end{aligned}$$

16. Treatment of Goodwill

Goodwill is the value of reputation of business houses in respect of the profits expected in future over and above the normal level of profits earned by undertakings belonging to the same class of business. In other words, goodwill is the present value of a firm's anticipated super normal earnings. The term super normal earnings means the excess of earnings attributable to operating tangible and intangible assets (other than goodwill) over and above the normal rate of return earned by representative firms in the same industry. It is observed that when a man pays for goodwill, he pays for something which places him in the position of being able to earn more money than he would be able to by his own unaided efforts. Goodwill is an intangible asset but not a fictitious one.

The following are some of the factors that generally contribute to the value of goodwill of a firm:

- (i) Quality of goods sold
- (ii) Location of the business unit
- (iii) Reputation of the owners
- (iv) Monopolistic nature of the business
- (v) Risk involved in the business
- (vi) Efficiency of management
- (vii) Possibility of competition
- (viii) Government attitude
- (ix) Possession of special contracts for availability of materials
- (x) Trends of profits, etc.

Whenever there is any change in the existing relationship of the partners, some partners may have to sacrifice their future profits and some other partners may gain. Those who are sacrificing future profit should be compensated by others who are gaining. As a result, the need for the valuation of goodwill in a firm may arise in the following circumstances:

- (a) Where the profit sharing ratio amongst the partners is changed.
- (b) When a new partner is admitted.
- (c) When a partner retires or dies.
- (d) When the business is sold, and
- (e) When a firm is amalgamated with another firm.

17. METHODS OF VALUATION OF GOODWILL

One of the main factors contributing to the value of goodwill is the earning capacity of the business. Following are the usual methods of calculating the value of goodwill:

(i) *Average Profit Method*

Goodwill is sometimes valued on the basis of a certain number of years' purchase of the average profits of the past few years.

Usually in examination, on question on partnership the candidates are asked to calculate the value of goodwill of the firm at so many years' purchase of average profits for so many past year' profits i.e. the average profits are ascertained and then it is multiplied by a particular number, say 3 or 4 representing the number of years' purchase. Suppose on 1st April, 2007 on the admission of a new partner, it is agreed that goodwill of the firm is valued at three years purchase of average profits for the last five years. Further, suppose the profits for last five years have been as follows:

	Rs.
For the year ended 31st March 2007	10,740
For the year ended 31st March 2006	7,900
For the year ended 31st March 2005	5,430
For the year ended 31st March 2004	400 (loss)
For the year ended 31st March 2003	8,500

Value of goodwill will be calculated as follows:

$$\begin{aligned} \text{Total profits for the last 5 years} &= \text{Rs. } (10,740 + 7,900 + 5,430 - 400 + 8,500) \\ &= \text{Rs. } 32,170 \end{aligned}$$

$$\text{Average profits} = \text{Rs. } \frac{32,170}{5} = \text{Rs. } 6,434$$

Three years' purchase of the above mentioned average profit

$$\text{Rs. } 6,434 \times 3 = \text{Rs. } 19,302$$

Hence, value of goodwill = Rs. 19,302

(ii) *Super Profit Method*

In this case the future maintainable profits of the firm are compared with the normal profits for the firm. Normal earnings of a business can be judged only in the light of normal rate of earning and the capital employed in the business.

Hence, this method of valuing goodwill would require the following information:

- (i) A normal rate of return for representative firms in the industry.
- (ii) The fair value of capital employed.

(iii) Estimated future maintainable profits.

The normal rate of earning is that rate of earning which investors in general expect on their investments in the particular type of industry. Normal rate of earning depends upon the risk attached to the investment, bank rate, market need and the period of investment.

Capital employed may be expressed as aggregate of capital and reserves less the amount of non-trading assets such as investments. The capital employed may also be ascertained by adding up the present values of trading assets and deducting all liabilities. Super profit is the simple difference between future maintainable operating profit and normal profit.

There are three methods of calculating goodwill based on super profit:

(a) *Purchase of super profit*

As per this method, value of goodwill be obtained by multiplying super profit by a certain number of years.

(b) *Annuity method*

Goodwill according to the annuity method is the present value of a terminal annuity of super profit for a reasonable period during which the super profit is likely to occur. It is calculated as:

$$\text{Super profit} \times \text{Annuity rate.}$$

(c) *Capitalisation of super profit*

In this method, the value of goodwill is arrived at by capitalising the super profit at the normal rate of return. It is calculated as:

$$\frac{\text{Super profit} \times 100}{\text{Normal rate of return}}$$

Illustration 9 :

A firm of X,Y and Z has a total capital investment of Rs. 2,25,000. The firm earned net profit during the last four years as Rs. 35,000, Rs. 40,000, Rs. 60,000 and Rs. 50,000. The fair return on the net capital employed is 15%. Find out the value of goodwill if it is based on 3 years' purchase of the average super profits of past four years.

Solution :

	Rs.
Total Profits earned during four years	1,85,000
Average annual profit Rs. $1,85,000 \div 4$	46,250
Fair return on capital employed – 15% of Rs. 2,25,000	33,750
Super Profit (Rs. 46,250 – Rs. 33,750)	12,500
Value of goodwill being 3 years' purchases of the average Super profit = Rs. $12,500 \times 3$	37,500

(iii) *Capitalisation Method:*

The capitalisation of profit method values goodwill at the excess of capital that should have been employed for earning the average profit over the capital which has been actually employed. In this method the value of whole business is found by using the formula:

$$\frac{\text{Average annual profit} \times 100}{\text{Normal rate of return}}$$

From this figure, the net assets (excluding goodwill) of the firm are deducted and the resultant value will be the goodwill.

Example: Average profit of a firm is Rs. 48,000

The rate of capitalisation is 12%

Assets and liabilities of the firm are Rs. 4,00,000 and 1,70,000 respectively.

Value of goodwill be: $\frac{48,000}{12} \times 100 = (4,00,000 - 1,70,000)$

= Rs. 4, 00,000 – Rs. 2, 30,000

= Rs. 1, 70,000

18. ACCOUNTING TREATMENT OF GOODWILL ON ADMISSION OF A PARTNER

Whenever a new partner is admitted, he is generally expected to pay cash to old partners for his share of goodwill for the right he acquires to share in super profits of the firm in future. Strictly, such a payment should be made only when there are super profits but in actual practice, some premium or goodwill may have to be paid by the new partner on his admission even when the business of the firm is not unusually profitable and constantly there are no super profits. The payment is made to the old partners for the sacrifice they make on their shares of profits for future. It is not necessary that the new partner must bring cash for his share of goodwill, only adjustment may be made for goodwill.

As a principal it should be ensured that goodwill should be recorded in the books of account only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess should be treated as goodwill. For example, when a partnership firm of X and Y purchases the net assets of Z amounting to Rs. 6,00,000 for Rs. 6,50,000 in cash, the additional payment of Rs. 50,000 is a payment for goodwill in cash. It is a case of purchased goodwill (an asset) and can be recorded in the books of account of X and Y. Therefore, only purchased goodwill should be recorded in the books of account whether the payment is made directly in cash or money's worth. When no payment is made for the purchase of goodwill, it is a case of internally, generated goodwill or inherent goodwill. For instance, in the event of reconstitution of the firm as a result of admission, retirement, death or change in profit sharing ratio, goodwill of the firm is evaluated. In such cases, the value of goodwill should not be brought into books of account as it is an inherent or self generated goodwill and no money or money's worth has been paid for it. Then goodwill should be calculated as per any of the methods stated above and adjusted through the capital accounts of the partners. Hence no goodwill account should be raised in the books of account on reconstitution of the firm or change in the profit sharing ratio among the partners. Therefore, it is stated that the internally generated or inherent goodwill should not be raised in the books of account. Instead it should be treated through the capital accounts of the concerned partners. In no case, the goodwill raised should be shown in the balance sheet.

In the light of the above discussion, the various alternative courses for the accounting treatment of goodwill on admission of a partner are as follows:

(i) *When the incoming partner brings in the required amount of goodwill and this amount is retained in the business*

In this case amount of goodwill brought in by the incoming partner along with his share of capital is credited to his capital account and later transfer the amount of goodwill to the old partners in the sacrificing ratio. In such a case following entries are passed:

(a) Cash/Bank A/c	Dr.
To New Partner's Capital A/c	
(Being amount of goodwill and capital brought by the new partner)	
(b) New Partner's Capital A/c	Dr.

(Being the amount of goodwill brought in by the new partner is shared by the old partners in the sacrificing ratio)

In this case the amount of goodwill is withdrawn by the partners in the sacrificing ratio and the entry for withdrawal will be:

(Being the amount of goodwill brought in by the new partner is withdrawn by the old partners in the sacrificing ratio)

In this case, the value of goodwill should not be raised in the books. Since it is inherent goodwill, it is preferable that such value of goodwill should be adjusted through partners' capital accounts. The new partners capital is debited with the share of goodwill and the amount is credited to old partners' capital accounts in the ratio in which they make sacrifice of profits. The journal entry will be:

(Being the amount of goodwill credited to old partners in the sacrificing ratio by debiting the new partners' capital account)

Goodwill A/c	Dr.	(full value)
To Old Partners' Capital A/c		(old profit sharing ratio)
(Being the goodwill raised in the books at its full value)		

In this case, the amount brought in by the new partner will be shared by the old partners in the sacrificing ratio and the portion of amount of goodwill not brought in by the new partner is adjusted through the capital accounts of partners by debiting, new partner's capital account with the amount and crediting the old partners' capital accounts in their sacrificing ratio.

On 31st March, 2007 the following was balance sheet of P and Q who were carrying on business in partnership sharing profits and losses in the ratio of 5:3.

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	10,900	Furniture and Fittings	15,000
Capital Account		Stock	48,000
P	45,000	Sundry Debtors	16,500
Q	<u>27,000</u>	Cash	<u>3,400</u>
	<u>82,900</u>		<u>82,900</u>

On 1st April, 2007 R is admitted to the firm as a new partner, the new profit sharing ratio between P, Q and R is agreed upon as 7:5:4 respectively. R brings in Rs. 24,000 as his capital. R's share of goodwill is fixed at Rs. 5,000.

Show journal entries and balance sheet immediately after R's admission in each of the following cases:

- R brings cash for his share of goodwill and the old partners withdraw half of the amounts credited to their accounts for goodwill brought in by R.
- R does not bring anything by way of his share of goodwill.
- R brings Rs. 3,000 as his share of goodwill and an adjustment in capital accounts is made for the balance amount.

Solution:

(a) Journal Entries			
		<i>Rs.</i>	<i>Rs.</i>
Cash A/c	Dr.	24,000	
To R's Capital A/c			24,000
(Cash brought in by R as his capital)			
Cash Account	Dr.	5,000	
To P's Capital Account			3,750
To Q's Capital Account			1,250
(Goodwill brought in by R credited to old partners in their ratio of sacrifice i.e., 3:1)			
P's Capital Account	Dr.	1,875	
Q's Capital Account	Dr.	625	
To Cash			2,500
(Half of the amount of goodwill credited to old partners withdrawn by them in cash)			

Balance Sheet of P, Q and R as on 1st April, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	10,900	Furniture and Fittings	15,000
Capital Accounts		Stock	48,000
P	46,875	Sundry Debtors	16,500
Q	27,625	Cash	29,900
R	24,000		

		<u>1,09,400</u>	<u>1,09,400</u>
(b)	Journal Entries		
R's Capital Account	Dr.	Rs. 5,000	Rs.
To P's Capital Account			3,750
To Q's Capital Account			1,250
(Being R's share of goodwill credited to old partners' capital account in the sacrificing ratio on his admission, credit being given to old partners in their old profit sharing ratio)			
Cash Account	Dr.	24,000	
To R's Capital Account			24,000
(Capital brought in by R)			

Balance Sheet of P,Q and R as on 1st April, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	10,900	Furniture and Fittings	15,000
Capital Account		Stock	48,000
P	48,750	Sundry Debtors	16,500
Q	28,250	Cash	27,400
R	<u>19,000</u>		
	<u>1,06,900</u>		<u>1,06,900</u>

Alternatively:

Goodwill Account	Dr.	Rs. 20,000	Rs.
To P's Capital Account			12,500
To Q's Capital Account			7,500
(For raising the full value goodwill)			
Cash Account	Dr.	24,000	
To R's Capital Account			24,000
(Capital brought in by R)			
P's Capital Account	Dr.	8,750	
Q's Capital Account	Dr.	6,250	
R's Capital Account	Dr.	5,000	
To Goodwill Account			20,000
(Goodwill Account written off by transferring to the partners' capital account in the new profit sharing ratio)			

**Balance Sheet of P, Q and R
as on 1st April, 2007**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	10,900	Furniture and Fittings	15,000
Capital Accounts		Stock	48,000
P	48,750	Sundry Debtors	16,500

Q	28,250	Cash	27,400
R	<u>19,000</u>		
	<u>1,06,900</u>		<u>1,06,900</u>

(c) **Journal Entries**

		Rs.	Rs.
Cash Account	Dr.	24,000	
To R's Capital Account			24,000
(Capital brought in by R)			
Cash Account	Dr.	3,000	
To P's Capital Account			2,250
To Q's Capital Account			750
(Being the amount of goodwill brought on by R credited to old partners in sacrificing ratio)			
R's Capital Account	Dr.	2,000	
To P's Capital Account			1,500
To Q's Capital Account			500
(Being portion of R's share of goodwill adjusted through the capital account by debiting his capital account and credited old partners capital accounts in the sacrificing ratio.)			

**Balance Sheet of P, Q and R
as on 1st April, 2007**

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	10,900	Furniture and Fittings	15,000
Capital Accounts		Stock	48,000
P	48,750	Sundry Debtors	16,500
Q	28,250	Cash	30,400
R	<u>22,000</u>		
	<u>1,09,900</u>		<u>1,09,900</u>

19. GOODWILL TO BE INFERRED

Sometime the value of goodwill has to be inferred from the agreement of capital and profit sharing ratio among the partners. Suppose, A and B share profits in the ratio 2:1 and their capitals stands at Rs. 20,000 and Rs. 10,000 and they admit C who brings Rs. 14,000 and is given 1/4th share in future profits. Now C's capital should be 1/4th of the total capital or in other words, the combined capital of A and B should be three times that of C's capital. Since the existing total capital of A and B is only Rs. 30,000 there is goodwill of Rs. 12,000. On the same capital consideration, goodwill may be attached to a particular partner on formation of partnership. For example, if A and B form partnership agreeing to share profits equally and they contribute Rs. 12,000 and Rs. 9,000 respectively, it can be inferred that a goodwill of Rs. 3,000 attaches to A.

20. ADJUSTMENT OF GOODWILL ON CHANGE IN PROFIT SHARING RATIO

Whenever there is a change in profit sharing ratio of the existing partners, there arises the need for valuation of goodwill. A change in profit sharing ratio results in gain to one partner and loss to the other. As a result, the partner who gains from the new ratio has to compensate the partner who loses. The gaining partner, in respect of share of profit, may buy his share of profits from any one or two partners, as the case may be. The partner who sells the share may sacrifice

in equal or unequal proportions. The amount of goodwill credited to partner(s) from whom the gaining partner purchases his share is always in proportion to the sacrifice made. The journal entry for his purpose is to debit the partner's capital account (one who gains) with the proportionate share of goodwill and credit the capital account or accounts of the partners (who lose) with the same amount. Alternatively, goodwill is raised in the books of the firm by crediting partners' capital account in their old profit sharing ratio and then immediately written off by debiting the partners' capital accounts in the new profit sharing ratio.

Illustration 11:

On 1st April, 2007 A, B and C who were sharing profits and losses in the ratio of 5:3:2 respectively decided to become equal partners. Goodwill of the firm was valued at Rs. 45,000. It was also decided to appreciate the book value of land and buildings by Rs. 14,000. No goodwill account appeared in the books of the firm and none was opened on change in profit sharing ratio.

Pass journal entries to make the necessary adjustments.

Solution:

Journal Entries

		Rs.	Rs.
Land and Buildings Account	Dr.	14,000	
To Revaluation Account			14,000
(Appreciation in the value of land and buildings)			
Revaluation Account	Dr.	14,000	
To A's Capital Account			7,000
To B's Capital Account			4,200
To C's Capital Account			2,800
(Transfer of profit on revaluation to partners' capital accounts in old profit sharing ratio)			
B's Capital Account	Dr.	1,500	
C's Capital Account	Dr.	6,000	
To A's Capital Account			7,500
(Adjustment for goodwill on change in profit sharing ratio)			

Working Notes:

$$\text{Old profit sharing ratio} = \frac{5}{10} : \frac{3}{10} : \frac{2}{10}$$

$$\text{New profit sharing ratio} = \frac{1}{3} : \frac{1}{3} : \frac{1}{3}$$

$$\text{A loses} = \frac{5}{10} - \frac{1}{3} = \frac{15 - 10}{30} = \frac{5}{30}$$

$$\text{B gains} = \frac{1}{3} - \frac{3}{10} = \frac{10 - 9}{30} = \frac{1}{30}$$

$$\text{C gains} = \frac{1}{3} - \frac{2}{10} = \frac{10 - 6}{30} = \frac{4}{30}$$

A will be credited with $\frac{5}{30} \times 45,000$ or Rs. 7,500 for goodwill

B will be debited with $\frac{1}{30} \times 45,000$ or Rs. 1,500 and

C will be debited with $\frac{4}{30} \times 45,000$ or Rs. 6,000.

21. CONTRIBUTION AND PURCHASE OF SHARE BY A PARTNER

A new partner may either purchase his share of profits from one or more of the existing partners or he may contribute to the assets of the firm. In the former case, the total capital of the firm does not change; the amount brought in by the new partner is paid to the partners from whom share is purchased. In the latter case, however, the total capital of the firm is augmented by the amount brought in by the new partner. Suppose, A and B share profits and losses in the ratio of 2:1 and their capitals stand at Rs. 10,000 and Rs. 5,000 respectively. If C is admitted and he buys 1/5th share from A, C will bring Rs. $15,000 \times \frac{1}{5} =$ Rs. 3,000 in cash which will be withdrawn by A. The new balances of the capital accounts of A, B and C will be Rs. 7,000, Rs. 5,000 and 3,000 respectively. If C contributes to the capital for 1/5th share of profits, he will bring Rs. $15,000 \times \frac{5}{4} \times \frac{1}{5} =$ Rs. 3,750. Total capital of the new firm will be Rs. 18,750.

22. ADJUSTMENT REGARDING CAPITAL OF PARTNERS

It is often agreed that after the admission of a new partner, capitals of all the partners should be proportion to their respective share in profit. The basis may be the amount of capital brought in by the new partner or the partner himself may be required to bring in capital equal to his share with firm. If the new partner's capital is given the total capital of the firm should be ascertained on that basis. Then the capital required for each one of the old partners should be ascertained and it should be compared with the actual balance in the account of the partner concerned, adjustments may then be made in cash or through current accounts to bring the balances of capital accounts of all the old partners to the desired figures. Suppose, C brings in Rs. 10,000 for 1/5th share of profits. Total capital of the firm should be Rs. $10,000 \times 5$ or Rs. 50,000. If A and B are to share profits as to A $\frac{1}{2}$ and B $\frac{3}{10}$, then A's capital account should show a balance of Rs. $50,000 \times \frac{1}{2}$ or Rs. 25,000 and B's capital should show a balance of Rs. $50,000 \times \frac{3}{10}$ or Rs. 15,000. If A's capital account shows a balance of Rs. 24,000 and the capital account of B shows a balance of Rs. 16,500, A will bring in Rs. 1,000 and B will withdraw Rs. 1,500.

Alternatively, the new partner may be required to bring capital on the basis of capital of old partners. Suppose the capital accounts A and B after all adjustments are Rs. 32,000 and Rs. 18,000 respectively and C is admitted as a new partner to whom 1/5th share of profits is given. Then

$$\text{C's Share} = \frac{1}{5}$$

$$\text{Remaining share} = 1 - \frac{1}{5} = \frac{4}{5}$$

$$\text{Combined capital of A and B} = \text{Rs. } 32,000 + \text{Rs. } 18,000 = \text{Rs. } 50,000$$

$$\text{Total Capital} = 50,000 \times \frac{5}{4} = \text{Rs. } 62,500$$

$$\text{C's Capital} = \text{Rs. } 62,500 \times \frac{1}{5} = \text{Rs. } 12,500$$

If A and B are to share profits as to A $\frac{1}{2}$ and B $\frac{3}{10}$, then

$$\text{A's Capital} = \text{Rs. } 62,500 \times \frac{1}{2} = \text{Rs. } 31,250$$

$$\text{B's Capital} = \text{Rs. } 63,500 \times \frac{3}{10} = \text{Rs. } 18,750$$

A will withdraw Rs. 750 and B will bring in Rs. 750.

Illustration 12 :

A and B sharing profits in proportion of three-fourth and one-fourth showed the following as their Balance Sheet as on 31st March, 2007:

<i>Liabilities</i>		<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Creditors		37,500	Cash at Bank	22,500
General Reserve		4,000	Bills Receivable	3,000
Capital Account:			Debtors	16,000
A	30,000		Stock	20,000
B	<u>16,000</u>	46,000	Office Furniture	1,000
			Land and Buildings	<u>25,000</u>
		<u>87,500</u>		<u>87,500</u>

They admit C into partnership on 1st April, 2007 on the following terms:

- (1) That C pays Rs. 10,000 as his capital for a fifth share in the future profits.
- (2) That a goodwill of the new firm be valued at Rs. 20,000 and C brings his share of goodwill.
- (3) That a stock and furniture be reduced by 10% and a 5% provision for doubtful debts be created on debtors.
- (4) That the value of land and buildings be appreciated by 20%.
- (5) That the capital accounts of all the partners be re-adjusted on the basis of their profits-sharing arrangements and any additional amount be immediately withdrawn by them.

Pass the journal entries, prepare the Profit and Loss Adjustment Account (Revaluation Account) Partners Capital Account and the Opening Balance Sheet of the new firm.

Solution:

Journal Entries

		<i>Rs.</i>	<i>Rs.</i>
Profit and Loss Adjustment Account	Dr.	2,900	
To Stock			2,000
To Office Furniture			100
To Provision for the doubtful debts			800
(Being the adjustment for writing down the value of assets)			
Land and Buildings Account	Dr.	5,000	
To Profit and Loss Adjustment Account			5,000
(Being the adjustment to appreciation in the value of Land and Buildings)			
		<i>Rs.</i>	<i>Rs.</i>
General Reserve Account	Dr.	4,000	
To A's capital Account			3,000

To B's Capital Account			1,000
(Being the transfer of Reserve to partners capital accounts in the profit sharing ratio)			
Profit and Loss Adjustment Account	Dr.	2,100	
To A's Capital Account			1,575
To B's Capital Account			525
(Being the transfer of profit arising from adjustments to Partners' Capital Accounts in their profit-sharing proportions)			
Bank	Dr.	14,000	
To C's Capital Account			14,000
(Being the amount brought in by C as his share capital and 1/4th share of goodwill)			
C's Capital Account	Dr.	4,000	
To A's Capital Account			3,000
To B's Capital Account			1,000
(Being the share of goodwill brought in by the incoming partner credited to old partners in their sacrificing ratio)			
A's Capital Account	Dr.	7,575	
To Bank			7,575
(Being the withdrawal of excess of capital over profit-sharing proportion)			
B's Capital Account	Dr.	8,525	
To Bank			8,525
(Being the withdrawal of excess of capital over his profit sharing proportion)			

Profit and Loss Adjustment account			
Dr.			Cr.
	Rs.		Rs.
To Stock	2,000	By Land and Buildings	5,000
To Office Furniture	100		
To Provision for Doubtful Debts	800		
To Transfer of Profits of Capital Accounts			
A 3/4th	1,575		
B 1/4th	<u>525</u>		
	2,100		
	<u>5,000</u>		<u>5,000</u>

A's Capital Account			
	Rs.		Rs.
To Bank	7,575	By Balance b/d	30,000
To Balance c/d	30,000	By General Reserve	3,000
		By Profit and Loss Adjustment A/c	1,575
		By C's Capital A/c	<u>3,000</u>
	<u>37,575</u>		<u>37,575</u>
		By Balance b/d	30,000

B's Capital Account

	Rs.		Rs.
To Bank	8,525	By Balance b/d	16,000
To Balance c/d	10,000	By General Reserve	1,000
		By Profit and Loss	
		Adjustment A/c	525
		By C's Capital A/c	1,000
	<u>18,525</u>		<u>18,525</u>
		By Balance b/d	10,000

C's Capital Account

	Rs.		Rs.
To A's Capital A/c	3,000	By Bank	14,000
To B's Capital A/c	1,000		
To Balance c/d	<u>10,000</u>		
	<u>14,000</u>		<u>14,000</u>

Balance Sheet of A, B and C as at 1st April, 2007

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Sundry Creditors		37,500	Cash at Bank		20,400
Capital Account:			Bills Receivable		3,000
A	30,000				
B	10,000		Sundry Debtors	16,000	
C	<u>10,000</u>	50,000	Less: Provision for		
			Doubtful Debts		
			@ 5%	<u>800</u>	15,200
			Stock		18,000
			Office Furniture		900
			Land and Building		<u>30,000</u>
		<u>87,500</u>			<u>87,500</u>

Notes: From the above Balance Sheet, it is clear that the Capitals of the partners now bear the same proportions as their profit sharing arrangements.

Illustration: 13

Ajay and Binoy are partners in a firm sharing profits and losses in the ratio of 2:1 respectively. On 31st March 2007 their balance sheet stood as follows:

Liabilities	(Rs.)	Assets	(Rs.)
Bills payable	6,000	Cash at bank	90,000
Sundry creditors	90,000	Bills receivable	20,000
General reserve	42,000	Sundry debtors	1,00,000
Ajay's capital	2,82,000	Stock	1,60,000
Binoy's capital	2,40,000	Furniture	40,000
		Machinery	2,50,000

6,60,000

6,60,000

On 1st April 2007, a new partner Harry was admitted into partnership on the following terms:

- (i) That Harry brings in cash Rs.60, 000 as goodwill for his one-third share in future profits.
- (ii) That Harry brings such an amount that his capital will be one-third of total capital of the new firm.
- (iii) That the value of stock to be raised to Rs. 1,68,000.
- (iv) That furniture and machinery be depreciated by 5% and 10% respectively.
- (v) That a provision for doubtful debts be created at 5% on sundry debtors.
- (vi) That the capital accounts of the partners be re-adjusted on the basis of their profit sharing ratio through their current accounts.

Prepare the necessary ledger accounts and the opening balance sheet of the new firm.

Solution:

Dr.	Revaluation Account		Cr.
Particulars	Rs.	Particulars	Rs.
To Furniture A/c	2,000	By Stock A/c	8,000
To Machinery A/c	25,000	By Ajay's Capital (2/3 loss)	16,000
To Provision for doubtful debts A/c		By Binoy's Capital (1/3 loss)	8,000
	5,000		
	-----		-----
	<u>32,000</u>		<u>32,000</u>
	Capital Accounts		

Capital Accounts

<i>Particulars</i>	<i>Ajay Rs.</i>	<i>Binoy Rs.</i>	<i>Harry Rs.</i>	<i>Particulars</i>	<i>Ajay Rs.</i>	<i>Binoy Rs.</i>	<i>Harry Rs.</i>
To Revaluation A/c (Loss)	16,000	8,000	--	By Balance b/d	2,82,000	2,40,000	
To Ajay's Capital A/c (Goodwill)			40,000	By General Reserve	28,000	14,000	
To Binoy's Capital A/c (Goodwill)			20,000	By Bank (Goodwill)			60,000
To Binoy's Current A/c		66,000		By Harry's Capital A/c (Goodwill)	40,000	20,000	
To Balance c/d	<u>4,00,000</u>	<u>2,00,000</u>	<u>3,00,000</u>	By Bank			3,00,000
	<u>4,16,000</u>	<u>2,74,000</u>	<u>3,60,000</u>	By Ajay's Current A/c	<u>66,000</u>	-----	-----
					<u>4,16,000</u>	<u>2,74,000</u>	<u>3,60,000</u>

**Balance Sheet of Ajay, Binoy and Harry
as on 1st April, 2007**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Bills Payable	6,000	Cash at Bank	4,50,000
Sundry Creditors	90,000	Bills Receivables	20,000
Binoy's Current A/c	66,000	Sundry Debtors	1,00,000
Ajay's Capital A/c	4,00,000	<u>Less</u> : Provision for doubtful debts	<u>5,000</u>
Binoy's Capital A/c	2,00,000	Stock	1,68,000
Harry's Capital A/c	3,00,000	Furniture	38,000

		Machinery	2,25,000
		Ajay's Current Account	66,000
	-----		-----
	10,62,000		10,62,000

Working Notes :

(i) Calculation of Harry's Capital

Total Capital :

Ajay's : Rs. (2,82,000 + 28,000 + 40,000 – 16,000) = Rs. 3,34,000

Binoy's : Rs. (2,40,000 + 14,000 + 20,000 – 8,000) = Rs. 2,66,000

Total capital of Ajay and Binoy before Harry's Admission = Rs. 6,00,000

This capital is for $1\frac{1}{3} = \frac{2}{3}$ share

So total capital of new firm : Rs. 6,00,000 $\times \frac{3}{2}$ = Rs. 9,00,000

Harry's Capital = $\frac{1}{3} \times$ Rs. 9,00,000 = Rs. 3,00,000

(ii) Calculation of new profit sharing ratio and capital of Ajay and Binoy

Harry's share = $\frac{1}{3}$

Balance = $1\frac{1}{3} = \frac{2}{3}$ to be shared by Ajay and Binoy

Ajay's new share = $\frac{2}{3} \times \frac{2}{3} = \frac{4}{9}$

Binoy's new share = $\frac{2}{3} \times \frac{1}{3} = \frac{2}{9}$

New profit share ratio = 4 : 2 : 3

Ajay's capital in new firm = $\frac{4}{9} \times$ Rs. 9,00,000 = Rs. 4,00,000

Binoy's capital in new firm = $\frac{2}{9} \times$ Rs. 9,00,000 = Rs. 2,00,000

Adjustment of capitals is made through partners' current accounts

Sacrifice by Ajay = $\frac{2}{3} - \frac{4}{9} = \frac{2}{9}$

Sacrifice by Binoy = $\frac{1}{3} - \frac{2}{9} = \frac{1}{9}$

Sacrifice ratio = 2 : 1

So goodwill distributed to Ajay and Binoy in the ratio of 2 : 1 respectively.

23. Retirement of a Partner

According to Section 32(1) of the Indian Partnership Act, a partner may retire:

- with the consent of all the partners;
- in accordance with an express agreement by the partners;
- where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire.

Generally, the business of the partnership firm may not come to an end when one of the partners retires. Other partners continue to run the business of the firm.

Just as a number of adjustments have to be made on the admission of a partner, a number of similar adjustments have to be made before a partner retires. These adjustments may be as regard to reserves and undistributed profits, revaluation of assets and liabilities, profits sharing ratio, goodwill etc.

24. TREATMENT OF RESERVES AND UNDISTRIBUTED PROFIT ON RETIREMENT

Before a partner retires, reserves created out of profits or balances in profit and loss account must be transferred to the capital accounts of all the partners in the ratio in which they share profits and losses at the time of retirement (old ratio). It is done so that the retiring partner may get his share of accumulated profits and may contribute his share of the loss that has not been transferred to capital accounts so far. Alternatively, only the share of the retiring partner is credited to his capital account for his share of profit.

The journal will be:

Reserves or Profit and Loss A/c Dr.
 To All Partners Capital A/cs

(Reserves/balance in profit and loss account transferred to the capital accounts of all the partners in old profit sharing ratio)

The alternative entry will be:

Reserves or Profit and Loss A/c Dr.
 To Retiring Partner's Capital A/c

(Reserves/balances in profit and loss account transferred to the capital account of retiring partner, his share only)

25. REVALUATION OF ASSETS AND LIABILITIES ON RETIREMENT OF A PARTNER

Before a partner retires all the assets and liabilities of the firm are revalued as in the case of admission of a partner. Any profit or loss resulting from such revaluation is transferred to all the partners' capital accounts in their profit sharing ratio. A Revaluation Account or Profit and Loss Adjustment Account is opened which is debited for all decrease in the book value of assets and all increase in liabilities and is credited for all increase in the value of assets and all decrease in liabilities. The balance is transferred to the capital accounts of all the partners.

Illustration 14:

A, B and C are partners sharing profits and losses in the ratio of 3:2:1 and on the retirement of C, the various assets and liabilities are revalued as under:

	<i>Book Value</i> Rs	<i>Revalued Value</i> Rs.
Plant and machinery	35,000	43,000
Sundry creditors	10,000	9,000
Stock	15,000	13,000

Pass journal entries on revaluation of these assets and liabilities.

Solution:

Journal Entries		<i>Rs.</i>	<i>Rs.</i>
Revaluation Account	Dr.	2,000	
To Stock			2,000
(Being fall in value of stock debited to revaluation account)			
Plant and machinery A/c	Dr.	8,000	
Sundry creditors	Dr.	1,000	
To Revaluation A/c			9,000
(Being gain on revaluation of plant and machinery and sundry creditors credited to revaluation account)			
Revaluation Account	Dr.	7,000	
To A's Capital A/c			3,500

To B's Capital A/c	2,333
To C's Capital A/c	1,167
(Being to revaluation profit transferred to all partners in the old profit sharing ratio.)	

If adjustments have to be made for profit or loss on revaluation without altering the values of assets and liabilities, a Memorandum Revaluation Account is opened. In this case, besides the entries required for recording the profit or loss on revaluation of assets and liabilities some additional entries are necessary. These additional entries are made by reversing the original entries. The profit or loss disclosed by the original entries is transferred to all partners' capital account in the old ratio, but the profit or loss disclosed by the reversed entries is transferred to remaining partners' capital account in the new ratio. Hence, revaluation account under this method is called memorandum revaluation account.

If there is a loss on revaluation, first all the partners' capital accounts are debited and Memorandum Revaluation Account is credited with the amount of such a loss. Then after retirement has taken place, Memorandum Revaluation Account is closed by transfer of the amount to the remaining partners' capital accounts in the new profit sharing ratio.

26. CALCULATION OF NEW PROFIT SHARING RATIO ON RETIREMENT

Unless an intention to the contrary is expressed, the assumption should be made that on the retirement of a partner, the remaining partners continue to share profits and losses in the same relative ratio in which they were sharing profits and losses prior to retirement of the partner, the absolute shares of the remaining partners may increase but the ratio between the increased shares does not change because the increase itself is in that very ratio. Suppose A, B and C share profits and losses in the ratio of 7:4:3 and B retires. Now in the absence of an agreement to the contrary, A and C will continue to share profits and losses in the ratio of 7:3. However their absolute shares have gone up. Previously A and C got 7/14ths and 3/14ths of the profit respectively. However, if the remaining partners decide to distribute between themselves the share left by the retiring partner in a different ratio the relative profit sharing ratio between the remaining partners will also change. To continue the abovementioned example, suppose, A and C agree that one half of B's share be added to A's share and the other half of B's share be added to C's share.

Then A's share will be $\frac{7}{14} + \left(\frac{1}{2} \times \frac{4}{14}\right) = \frac{9}{14}$

and C's share will be $\frac{3}{14} + \left(\frac{1}{2} \times \frac{4}{14}\right) = \frac{5}{14}$. The new ratio between A and C will be 9:5.

Illustration 15:

On 31st March, 2007 the following Balance Sheet of A, B and C who were equal partners:

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	89,400	Cash in hand	1,800
General Reserves	1,50,000	Cash at Bank	39,700
A's Capital Account	2,40,000	Investments	50,000
B's Capital Account	1,90,000	Debtors	2,10,000
Liabilities	Rs.	Assets	Rs.
C's Capital Account	1,75,000	Less:	
		Provision for Bad	
Debts	2,200		2,07,800

	Stock	3,70,100
	Furniture and Fittings	<u>1,75,000</u>
<u>8,44,400</u>		<u>8,44,400</u>

On that date, A decided to retire due to ill health and the following adjustments were agreed upon by the partners:

- (i) Investments be appreciated by Rs. 15,000
- (ii) Provision for bad debts be brought upto 5% of debtors.
- (iii) Furniture be depreciated by 10%
- (iv) Stock be depreciated by Rs. 7,200

A was paid the amount due to him by means of cheque, the bank agreed to allow the necessary overdraft.

Pass journal entries to record the above mentioned transactions and show the balance sheet of the firm immediately after A's retirement.

Solution:

		<i>Dr.(Rs.)</i>	<i>Cr.(Rs.)</i>
General Reserve	Dr.	1,50,000	
To A's Capital Account			50,000
To B's Capital Account			50,000
To C's Capital Account			50,000
(Transfer to general reserve to capital accounts)			
Investments	Dr.	15,000	
To Revaluation Account			15,000
(Increase in the value of investments)			
Revaluation Account	Dr.	33,000	
To Provision for Bad Debts			8,300
To Furniture			17,500
To Stock			7,200
(Various adjustments as agreed upon by partners)			
A's Capital Account	Dr.	6,000	
B's Capital Account	Dr.	6,000	
C's Capital Account	Dr.	6,000	
To Revaluation Account			18,000
(Transfer of loss on revaluation to partners' capital account)			
A's Capital Account	Dr.	2,84,000	
To Bank			2,84,000
(Payment of the amount due to A on his retirement)			

Balance Sheet of B and C as on 1st April, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Bank Overdraft	2,44,300	Cash in Hand	1,800
Sundry Creditors	89,400	Investment	65,000
B's Capital Account	2,34,000	Debtors	2,10,000
C's Capital Account	2,19,000	Less:	
		Provision for Bad	
		Debts	<u>10,500</u>
			1,99,500
		Stock	3,62,900
		Furniture and Fittings	<u>1,57,500</u>

7,86,700

7,86,700

If the values of assets and liabilities were not being changed, the following would have been the journal entries:

		Rs.	Rs.
General Reserve	Dr.	1,50,000	
To A's Capital Account			50,000
To B's Capital Account			50,000
To C's Capital Account			50,000
(Transfer of general reserve to capital accounts)			
Investments	Dr.	15,000	
To Revaluation Account			15,000
(Increase in the value of investments)			
Revaluation Account	Dr.	33,000	
To Provision for Bad Debts			8,300
To Furniture			17,500
To Stock			7,200
(Various adjustments as agreed upon by partners)			
Capital Account	Dr.	6,000	
B's Capital Account	Dr.	6,000	
C's Capital Account	Dr.	6,000	
To Memorandum Revaluation Account			18,000
(Transfer of loss on revaluation to partners capital accounts)			
A's Capital Account	Dr.	2,84,000	
To Bank			2,84,000
(Payment to A on his retirement)			
Memorandum Revaluation Account	Dr.	18,000	
To B's Capital Account			9,000
To C's Capital Account			9,000
(Transfer to memorandum revaluation account to remaining partners' capital accounts in new profit sharing rate)			

Balance Sheet of B and C as on 1st April, 2007

Liabilities	Rs.	Assets	Rs.
Bank Overdraft	2,44,300	Cash in Hand	1,800
Sundry Creditors	89,400	Investments	50,000
B's Capital Account	2,43,000	Debtors	2,10,000
C's Capital Account	2,28,000	Less: Provision for	
		Bad Debts	<u>2,200</u>
		Stock	3,70,100
		Furniture and Fittings	<u>1,75,000</u>
	<u>8,04,700</u>		<u>8,04,700</u>

27. TREATMENT OF GOODWILL ON RETIREMENT

In case of retirement of a partner, goodwill is valued in the same manner in which it is valued in case of admission of partner.

In this case, the continuing partners will gain in terms of profit sharing ratio. Hence the continuing partners have to share the burden of the share of goodwill of the retiring partner in the

gaining ratio. In this case the retiring partner's capital account is credited with his share of goodwill and the continuing partner's capital account is debited with the amount in the gaining ratio. Alternatively the total value of the goodwill is raised by debiting the goodwill account and crediting all the partner's capital account in the old partners sharing ratio. Then goodwill may be written off by debiting the capital accounts of the remaining partners in the new ratio and crediting the goodwill account.

The net effect in the above cases is the same. The point to be remembered is that in no case, goodwill account will be shown in the books of account. In case the goodwill account is raised, it must be immediately written off.

Thus is not necessary that Goodwill Account must be opened; only capital accounts of the partners may be debited and credited with the necessary amounts. If entries are to be made with full value of goodwill, the amount of the goodwill should be credited to all partners' capital accounts in the old profit sharing ratio and should be debited to the remaining partners' capital accounts in the new profit sharing ratio. Alternatively, an entry may be passed only with the retiring partner's share of goodwill; retiring partner's capital account should be credited and the remaining partners' capital account should be debited in the ratio of gain.

28. RATIO OF GAINS

On retirement of a partner, the share of profits to other partners increase. In order to find ratio in which the remaining partners have gained, old share should be deducted from the new share. For example, if A, B and C share profits and losses in the ratio of 7:5:3 respectively and after B's retirement A and C decide to share profits and losses in the ratio of 3:2 respectively, and ratio of gain will be calculated as follows:

$$\begin{aligned}
 \text{A's old share} &= \frac{7}{15} \\
 \text{A's new share} &= \frac{3}{5} \\
 \text{A's gain} &= \frac{3}{5} - \frac{7}{15} = \frac{9-7}{15} = \frac{2}{15} \\
 \text{C's old share} &= \frac{3}{15} \\
 \text{C's new share} &= \frac{2}{5} \\
 \text{C's gain} &= \frac{2}{5} - \frac{3}{15} = \frac{6-3}{15} = \frac{3}{15}
 \end{aligned}$$

Hence ratio of gain between A and C is 2:3

Illustration 16:

Following is balance sheet of A, B and C who share profits and losses in the ratio of 7: 5: 3 respectively.

Balance Sheet of A, B and C as on 1st March, 2007

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	15,400	Furniture and Fittings	12,000
Capital Accounts		Sundry Debtors	16,000
A	40,000	Stock	44,000

B	25,000	Cash at Bank	18,400
C	<u>10,000</u>		
	<u>90,400</u>		<u>90,400</u>

On 31st March, 2007 C retires on the condition that he be immediately paid the amount due to him after making adjustment for goodwill which is valued at Rs.22,500. A and B agree to share profit and losses in future in the ratio of 8:7 respectively.

Show, journal entries and balance sheet in each of the following cases:

- Goodwill Account is raised at its full value but is written off immediately after C's retirement.
- Goodwill Account is raised only with C's share of goodwill.
- No Goodwill Account is raised but adjustment are made in the capital accounts with full value of goodwill.
- No Goodwill account is raised but adjustments are made in the capital accounts with retiring partner's share of goodwill.
- A and B pay privately to C for goodwill.

Solution:

(i) **Journal Entries**

		Rs.	Rs.
Goodwill Account	Dr.	22,500	
To A's Capital Account			10,500
To B's Capital Account			7,500
To C's Capital Account			4,500
(Goodwill Account raised at full value of goodwill)			
C's Capital A/c	Dr.	14,500	
To Bank			14,500
(Payment to C)			
A's Capital Account	Dr.	12,000	
B's Capital Account	Dr.	10,500	
To Goodwill Account			22,500
(Transfer of goodwill account to remaining partner's capital accounts in the new profit sharing ratio)			

Balance Sheet of A and B as on 1st April, 2007

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	15,400	Furniture and Fittings	12,000
A's Capital Account	38,500	Sundry Debtors	16,000
B's Capital Account	22,000	Stock	44,000
		Cash at Bank	<u>3,900</u>
	<u>75,900</u>		<u>75,900</u>

(ii) **Journal Entries**

		Rs.	Rs.
Goodwill Account	Dr.	4,500	
To C's Capital Account			4,500

(Credit given to C for his share of goodwill)

C's Capital Account	Dr.	14,500	
To Bank			14,500

(Payment to C)

A's Capital Account	Dr.	1,500	
B's Capital Account	Dr.	3,000	
To Goodwill Account			4,500

(Transfer of Goodwill Account to the remaining partners in the ratio of gain which turns out to be 1:2)*

*The ratio of gain in this case has been calculated as under:

$$\begin{aligned}
 \text{A's old share} &= \frac{7}{15} \\
 \text{A's new shares} &= \frac{8}{15} \\
 \text{A's gain} &= \frac{8}{15} - \frac{7}{15} = \frac{1}{15} \\
 \text{B's old share} &= \frac{5}{15} \\
 \text{B's new share} &= \frac{7}{15} \\
 \text{B's gain} &= \frac{7}{15} - \frac{5}{15} = \frac{2}{15}
 \end{aligned}$$

Hence ratio of gain between A and B is 1:2

The Balance Sheet will be the same as in case (i) above.

(iii) Journal Entries

		Rs.	Rs.
A's Capital Account	Dr.	12,000	
B's Capital Account	Dr.	10,500	
To A's Capital Account			10,500
To B's Capital Account			7,500
To C's Capital Account			4,500
(Value of goodwill debited to the remaining partners in the new profit sharing ratio and credited to all partners in the old profit sharing ratio)			
C's Capital Account	Dr.	14,500	
To Bank			14,500

(Payment to C)

Balance Sheet will be the same as in cases (i) and (ii) above.

(iv) Journal Entries

A's Capital Account	Dr.	1,500	
B's Capital Account	Dr.	3,000	
To C's Capital Account			4,500

(Retiring partner being credited with his share of goodwill which is debited to remaining partners in the ratio of gain 1:2)

C' Capital Account	Dr.	14,500	
To Bank			14,500
(Payment to C)			

Balance Sheet will be the same as in cases (i), (ii) and (iii)

(v) Journal Entries

C's Capital Account	Dr.	10,000	
To Bank			10,000
(Payment to C)			

Balance Sheet of A and B as on 1st April, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	15,400	Furniture and Fittings	12,000
A's Capital Account	40,000	Sundry Debtors	16,000
B's Capital Account	25,000	Stock	44,000
		Cash at Bank	<u>8,400</u>
	<u>80,400</u>		<u>80,400</u>

29. CAPITALS IN PROFIT SHARING RATIO

After the retirement of a partner, the remaining partners may decide that their capitals be in their new profit sharing ratio. For this purpose, the total capital of the new firm may be fixed which will then be divided among the remaining partners in their new profit sharing ratio. Alternatively the total of the balance of capital accounts of the remaining partners after all the adjustments in respect of retirement have been made may be considered to be the total capital of the firm which may then be reallocated to the different partners in their new profit sharing ratio. The adjustments in the capital accounts for this purpose may be made either by bringing in or payment of cash or through current accounts.

Illustration 17:

The balance sheet of Anil, Bashin and Cyril who were sharing profits in proportion to their capital stood as follows on 31st March, 2007.

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	6,900	Cash in Bank	5,500
General Reserve	18,000	Sundry Debtors	5,000
Capital Accounts:		Less : Provision	
Anil	20,000	for Bad Debts	<u>100</u>
Bashin	15,000	Stock	26,000
Cyril	10,000	Plant and Machinery	13,500
		Land and Buildings	<u>20,000</u>
	<u>69,900</u>		<u>69,900</u>

Bashin retired on the above date and the following was agreed upon.

- (i) That the provision for bad debts be brought upto 5% on debtors.
- (ii) That land and building be appreciated by 25%.
- (iii) That a provision of Rs. 350 be made in respect of outstanding legal charges.

- (iv) That the goodwill of the entire firm be fixed at Rs. 10,800 and Bashin's share of it be adjusted into the accounts of Anil and Cyril who are going to share future profits in the ratio of 5:3.
- (v) That the entire capital of the new firm be fixed at Rs. 48,000 and the capital accounts of the partners be made in their new profit sharing ratio; (actual cash to be brought in or paid off as the need be).

Pass Journal Entries, show Profit and Loss Adjustment Account and Capital Accounts and prepare Balance Sheet of Anil and Cyril.

Solution:

Journal Entries

		Rs.	Rs.
General Reserve	Dr.	18,000	
To Anil's Capital A/c			8,000
To Bashin's Capital A/c			6,000
To Cyril's Capital A/c			4,000
(Transfer of general reserve to capital accounts)			
Profit and Loss Adjustment A/c	Dr.	500	
To Provision for Bad Debts			150
To Outstanding Legal Expenses			350
(Increase in provision for bad debts and record of outstanding legal expenses)			
Land and Building	Dr.	5,000	
To Profit and Loss Adjustment Account			5,000
(Appreciation in the value of land and buildings)			
Profit and Loss Adjustment A/c	Dr.	4,500	
To Anil's Capital A/c			2,000
To Bashin's Capital A/c			1,500
To Cyril's Capital A/c			1,000
(Transfer of profit on revaluation)			
Anil's Capital Account	Dr.	1,950	
Cyril's Capital Account	Dr.	1,650	
To Bashin's Capital Account			3,600
(Bashin's share of goodwill debited to Anil and Cyril in ratio of gain which is 13:11)			
Bashin's Capital Account	Dr.	26,100	
To Bashin's Loan Account			26,100
(Transfer of Bashin's Capital Account to his loan Account)			
		Rs.	Rs.
Bank	Dr.	6,600	
To Anil's Capital Account			1,950
To Cyril's Capital Account			4,650
(Cash brought in by Anil and Cyril)			

Profit and Loss Adjustment Account

<i>Dr.</i>			<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
To Provision for Bad Debts	150	By Land and Buildings	5,000
To Outstanding Legal Expenses	350		
To Anil's Capital A/c (4/9 profit)	2,000		
To Bashin's Capital A/c (3/9 profit)	1,500		
To Cyril's Capital A/c (2/9 profit)	<u>1,000</u>		
	<u>5,000</u>		<u>5,000</u>

Capital Accounts

	<i>Anil Rs.</i>	<i>Bashin Rs.</i>	<i>Cyril Rs.</i>		<i>Anil Rs.</i>	<i>Bashin Rs.</i>	<i>Cyril Rs.</i>
To Bashin's Capitals A/c	1,950		1,650	By Balance b/d	20,000	15,000	10,000
To Bashin's Loan A/c		26,100		By General Reserve	8,000	6,000	4,000
To Balance c/d	30,000		18,000	By Profit and Loss Adjustment A/c	2,000	1,500	1,000
				By Anil Capital A/c		1,950	
				By Cyril's Capital A/c		1,650	
				By Bank	<u>1,950</u>		<u>4,650</u>
	<u>31,950</u>	<u>26,100</u>	<u>19,650</u>		<u>31,950</u>	<u>26,100</u>	<u>19,650</u>
				By Balance b/d	30,000		18,000

Balances Sheet of Anil and Cyril as on 1st April, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	6,900	Cash in Bank	12,100
Outstanding Legal Expenses	350	Sundry Debtors	5,000
Bashin's Loan Account	26,100	Less: Provision for Bad Debts	<u>250</u>
Capital Accounts:			4,750
Anil	30,000	Stock	26,000
Cyril	<u>18,000</u>	Plant and Machinery	13,500
		Land and Buildings	<u>25,000</u>
	<u>81,350</u>		<u>81,350</u>

Working Notes

$$\text{Anil's gain in profit} = \frac{5}{8} - \frac{4}{9} = \frac{45 - 32}{72} = \frac{13}{72}$$

$$\text{Cyril's gain in profit} = \frac{3}{8} - \frac{2}{9} = \frac{27 - 16}{72} = \frac{11}{72}$$

$$\text{Ratio of Gain} = 13:11$$

$$\text{Bashin's share of goodwill} = \text{Rs. } 10,800 \times \frac{3}{9} \text{ or Rs. } 3,600$$

$$\text{Anil's will be debited with Rs. } 3,600 \times \frac{13}{24} \text{ or Rs. } 1,950, \text{ and}$$

Cyril will be debited with Rs. $3,600 \times \frac{13}{24}$ or Rs. 1,650 for goodwill.

30. COMPUTATION OF RETIRING PARTNER'S INTEREST IN THE FIRM

The terms of the partnership agreement are to be observed while ascertaining the amount due to the retiring partner. Usually following items are taken into consideration while calculating the total amount due to the retiring partner:

- (a) Balance of the capital account of the retiring partner appearing in the last balance sheet;
- (b) Share of undistributed reserve and profit (loss) in the firm;
- (c) Share of firm's goodwill;
- (d) Share in the profit and loss on the revaluation of assets and liabilities;
- (e) Share of profit and loss till the date of retirement,
- (f) Salary and interest on capital or drawing till the date of his retirement.

31. PAYMENT OF RETIRING PARTNER'S INTEREST

The amount due to the retiring partner can be paid as per the terms of the partnership agreement. In case the terms of the agreement are silent the payment may be made as mutually agreed. The payment can be affected by any of the following methods:

- (i) *Lump sum Payment Method*: If the firm has adequate funds, the amount due to the retired partner may be paid forthwith. His Capital Account will be debited and Bank Account will be credited.
- (ii) *Installment Payment Method*: In order to avoid financial difficulties, a part or full payment due to the retired partner, may be deferred, In this case, the balance of his Capital Account will be transferred to his Loan Account which will be credited periodically with interest at the agreed rate on the outstanding balance and debited with payment on account until the balance is extinguished. The arrangement of installments may take the following two forms.
 - (a) *Decreasing Payment Method*: In this method, the total amount due is divided in a number of equal instalments and the instalment amount plus interest on the outstanding balance is paid out.
 - (b) *Equal Payment Method*: In this method, the total amount to be paid is divided in a number of equal instalments in such a way that the amount after including interest on the outstanding balance is always equal.

Illustration 18:

On 31st December, 2004 D retired from a partnership firm leaving Rs. 15,000 in the firm as a loan to be repaid in three annual instalments of Rs. 5,000 each plus interest at 8%p.a. on outstanding balances.

Show D's Loan Account

Solution:

D's Loan Account

Dr.

Cr.

2004			Rs.	2004			Rs.
Dec.31	To	Balance c/d	<u>15,000</u>	Dec.31	By	D's Capital A/c	<u>15,000</u>
2005				2005			
Dec. 31	To	Bank	6,200	Jan. 1	By	Balance b/d	15,000
Dec. 31	To	Balance c/d	<u>10,000</u>		By	Interest @ 8% on Rs. 15,000	<u>1,200</u>
			<u>16,200</u>				<u>16,200</u>
2006				2006			
Dec. 31	To	Bank	5,800	Jan.1	By	Balance b/d	10,000
Dec. 31	To	Balance c/d	<u>5,000</u>	Dec.31	By	Interest @ 8%	<u>800</u>
			<u>10,800</u>				<u>10,800</u>
2007				2007			
Dec. 31	To	Bank	5,400	Jan.1	By	Balance b/d	5,000
			<u>5,400</u>	Dec. 31	By	Interest @ 8% on Rs. 5,000	<u>400</u>
							<u>5,400</u>

32. PURCHASE OF RETIRING PARTNER'S SHARE BY REMAINING PARTNERS

The retiring partner's share may be purchased by the remaining partners in an agreed ratio. In such a case retiring partner's capital account is closed by transfer to the remaining partners capital accounts in the ratio in which they agree to purchase his share. When the remaining partners purchase the retiring partner's share, the retiring partner has to look to the remaining partners individual capacities for the satisfaction of his claim; the new firm as such will not be responsible.

In the examination, if the question states that the remaining partners purchase the retiring's partner's share but does not specify the proportion in which they purchase his share, the candidates should assume that it is done in the relative profit sharing ratio between the remaining partners; and if the new profit sharing ratio is given, the purchase should be taken to be in the ratio of gain.

Illustration 19 :

On 31st March, 2007 the balance of M/s. Ashok, Basu, and Clement, who were sharing profits and losses in proportion to their capitals, stood as follows:

Liabilities	Rs.	Assets	Rs.
Capital Accounts:		Land and Buildings	2,00,000
Ashok	3,00,000	Machinery	2,00,000
Basu	2,00,000	Closing Stock	1,00,000
Clement	<u>1,00,000</u>	Sundry Debtors	2,00,000
Sundry Creditors	<u>2,00,000</u>	Cash and Bank Balances	<u>1,00,000</u>
	<u>8,00,000</u>		<u>8,00,000</u>

On 31st March, 2007, Ashok desired to retire from the firm and the remaining partners decided to carry on. They agreed on the following terms and conditions:

- Land and building be appreciated by 30%

- (ii) Machinery be depreciated by 20%
- (iii) Closing stock to be valued at Rs. 80,000.
- (iv) Provision for bad debts be made at 5%.
- (v) Old credit balances of sundry creditors Rs. 10,000 be written back.
- (vi) Joint Life Policy of the partners surrendered and cash obtained Rs. 60,000.
- (vii) Goodwill of the entire firm be valued at Rs. 1,80,000 and Ashok's share of the goodwill be adjusted in the accounts Basu and Clement who would share the future profits equally.
- (viii) The total capital of the firm was to be the same as before retirement. Individual capitals of partners were to be in their profit sharing ratio.
- (ix) Amount due to Ashok was to be settled on the following basis:
50% on retirement and balance 50% within one year.

Prepare Revaluation Account, Capital Accounts of the Partners, Loan Account of Ashok, Cash Account and Balance Sheet as on 1st April 2007 of M/s. Basu and Clement.

Solution:

Dr.	Revaluation Account		Cr.
	Rs.		Rs.
To Machinery A/c	40,000	By Land and Building	60,000
To Closing Stock	20,000	By Sundry Creditors	10,000
To Provision for Bad Debts A/c	10,000	By Bank A/c (Joint Life Policy)	60,000
To Capital Accounts:			
Ashok	30,000		
Basu	20,000		
Clement	10,000		
	<u>60,000</u>		
	<u>1,30,000</u>		<u>1,30,000</u>

Capital Accounts					
	<i>Basu</i>	<i>Clement</i>		<i>Basu</i>	<i>Clement</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
To Ashok	30,000	60,000	By Balance b/d	2,00,000	1,00,000
Capital A/c (Goodwill)			By Revaluation A/c	20,000	10,000
To Balance c/d	3,00,000	3,00,000	By Bank (Additional capital)	1,10,000	2,50,000
	<u>3,30,000</u>	<u>3,60,000</u>		<u>3,30,000</u>	<u>3,60,000</u>
			By Balance b/d	3,00,000	3,00,000

Ashok's Capital Account			
	<i>Rs.</i>		<i>Rs.</i>
To Bank	2,10,000	By Balance b/d	3,00,000
To Ashok' Loan A/c	2,10,000	By Revaluation A/c	30,000
		By B's Capital A/c (Goodwill)	30,000
		By C's Capital A/c	60,000

		(Goodwill)	
	<u>4,20,000</u>		<u>4,20,000</u>
Ashok's Loan Account			
	Rs.		Rs.
To Balance c/d	<u>2,10,000</u>	By Ashok's Capital A/c	<u>2,10,000</u>
		By Balance b/d	2,10,000
Cash and Bank Account			
	Rs.		Rs.
To Balance b/d	1,00,000	By A's Capital A/c	2,10,000
To Revaluation A/c (J.L. Policy surrendered)	60,000	By Balance c/d	3,10,000
To Basu's Capital A/c	1,10,000		
To Clement's Capital A/c	<u>2,50,000</u>		
	<u>5,20,000</u>		<u>5,20,000</u>
To Balance b/d	3,10,000		

M/s. B and C Balance Sheet as on 1.4.2007			
<i>Liabilities</i>	Rs.	<i>Assets</i>	Rs.
Capital Accounts:		Land and Building	2,60,000
Basu	3,00,000	Machinery	1,60,000
Clement	<u>3,00,000</u>	Closing Stock	80,000
A's Loan A/c	2,10,000	Sundry Debtors	2,00,000
Sundry Creditors	1,90,000	Less: Provisions	
		for Bad Debts	<u>10,000</u>
		Cash and Bank	
		Balances	<u>3,10,000</u>
	<u>10,00,000</u>		<u>10,00,000</u>

Working Notes

- (1) Calculation of ratio of gain of remaining partners.

$$\begin{aligned} \text{Ratio of gain} &= \text{New ratio} - \text{Old ratio} \\ \text{Basu} &= 1/2 - 1/3 = 1/6 \\ \text{Clement} &= 1/2 - 1/3 = 2/6 \\ \text{Ratio gain} &= 1:2. \end{aligned}$$

- (2) Goodwill borne by Basu and Clement:

$$\begin{aligned} \text{Total goodwill of the firm} &= \text{Rs. } 1,80,000 \\ \text{Ashok's share} &= 1/2 \times \text{Rs. } 1,80,000 = 90,000 \end{aligned}$$

Ashok's share to be borne by Basu and Clement in their ratio of gain.

$$\begin{aligned} \text{Basu} &= 1/3 \times \text{Rs. } 90,000 = \text{Rs. } 30,000 \\ \text{Clement} &= 2/3 \times \text{Rs. } 90,000 = \text{Rs. } 60,000 \end{aligned}$$

33. DEATH OF A PARTNER

All the problems which arise on the retirement of a partner also arise on the death of a partner. However, there are a few additional points which have to be noted.

If the balance of deceased partner's capital account is not immediately paid in cash, the amount should be transferred to the deceased partner's Executors Account and not to any Loan Account.

A partner usually retires at the close of an accounting year when his capital account is credited with his share of profits for the year. But a partner's death may take place any day. Partnership deed may provide that in case of death of a partner during the currency of any accounting year, the deceased partner's capital account will be credited with his share of profits for the period for which he remained alive during the year on the basis of profits of the year preceding the year in which death takes place. Suppose, a partner C getting 1/3 share in profits died on 30 June 2007 and the profits for the year ended 31st March, 2007 have been Rs. 18,000. Then C's Capital Account is credited with Rs. 1500 ($\text{Rs. } 18,000 \times \frac{3}{12} \times \frac{1}{3} = \text{Rs. } 1,500$) for his share of profits for 3 months. Of course some other basis may also be provided for, or the partnership deed may provide that final accounts will be prepared to ascertain profits for the part of the year.

34. JOINT LIFE POLICY

Partners often take out a joint life policy to provide funds for settling the claims of the deceased partner. Annual premium is paid by the firm and on the death of a partner, the amount of the policy is received from the insurance company.

It is possible to treat a joint life policy in three ways in the books of account.

1. When Premium paid is treated as an Expense

Under this method, the annual premium is treated as an expense and debited to the Profit and Loss Account. On the death of a partner, the amount of the policy received by the firm is credited to all the partners' capital accounts in the profit sharing ratio.

The Journal entries will be as under:

(i) For payment of Premium of the Joint Life Policy

(a) Joint Life Insurance Premium A/c	Dr.
To Bank	
(Being amount of premium paid on joint life policy).	

(b) Profit and Loss A/c	Dr.
To Joint Life Insurance Premium A/c.	
(Being the amount of premium charged to Profit and Loss A/c)	

(ii) For Receipt of the Policy Money

Bank	Dr.
To All Partners' Capital A/cs	
(Being the policy money distributed among all partners in the profit sharing ratio)	

2. When Premium paid is treated as an Asset and Surrender Value is taken into account

Under this method Joint Life Policy Account is debited with the amount of premium as and when paid. At the end of the year the amount in excess of surrender value is treated as loss and

transferred to Profit and Loss Account. The balance in Joint Life Policy Account is shown as an asset in the balance sheet. The amount received on maturity of policy in excess of surrender value will be net gain and divided among all the partners in their profit sharing ratio.

The journal entries will be as under:

- | | | |
|-------|---|-----|
| (i) | Joint Life Policy A/c | Dr. |
| | To Bank | |
| | (Being the premium paid on policy) | |
| <hr/> | | |
| (ii) | Profit and Loss A/c | |
| | To Joint Life Policy A/c | |
| | (Being the adjustment of book value with the
surrender value i.e. excess of joint life policy over
the surrender value) | |
| <hr/> | | |
| (iii) | Bank A/c | Dr. |
| | To Joint Life Policy A/c | |
| | (Being amount received on maturity of policy) | |
| <hr/> | | |
| (iv) | Joint Life Policy A/c | Dr. |
| | To All Partners' Capital A/cs | |
| | (Being the amount received minus the surrender
value on that date distributed among the partners.) | |
| <hr/> | | |

3. *When Premium Paid is treated as an Asset and Life Policy Reserve Account is maintained.*

Under this method, whenever premium is paid, the amount of the premium is debited to Joint Life Policy Account. At the end of the year Profit and Loss account is debited and Joint Life Policy Reserve Account is credited with the amount of the premium paid for the year. Then in order to reduce the balances of Joint Life Policy Account and Joint Life Policy Reserve Account to the figure of surrender value of the policy, Joint Life Policy Reserve Account is debited and Joint Life Policy Account is credited with the difference between balance of Joint Life Policy Account and surrender value of the policy. The entries are repeated every year. On maturity of the policy, the amount received from the insurance company is credited to Joint Life Policy Account, Joint Life Policy Reserve Account is transferred to Joint Life Policy Account and the balance in Joint Life Policy Account is transferred to all the partners' capital accounts in their profit sharing ratio. The amount standing at the credit of Joint Life Policy Reserve Account may alternatively be transferred directly to partner's Capital Account in their profit sharing ratio.

The Journal entries will be as under:

- | | | |
|-------|---|-----|
| (i) | For payment of premium of the Joint Life Policy | |
| | Joint Life Policy A/c | Dr. |
| | To Bank A/c | |
| | (Being the amount of premium paid on Joint Life Policy) | |
| <hr/> | | |
| (ii) | For appropriation of amount equal to annual premium | |
| | Profit and Loss A/c | Dr. |
| | To Joint Life Policy Reserve A/c | |
| | (Being the amount transferred to Joint Life Policy Reserve Account) | |
| <hr/> | | |
| (iii) | For adjusting the difference between the premium paid and the increase in the surrender value | |

Dr.

Dr.

Dr.

Dr.

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Creditors	4,000	Goodwill	3,000
Bills Payable	2,000	Freehold Property	10,000
Capitals:		Joint Life Policy	2,000
A	10,000	Stock	5,500

B	6,000	Debtors	4,500
C	<u>4,000</u>	Cash	<u>1,000</u>
	<u>26,000</u>		<u>26,000</u>

A died on July 1, 2007. The firm had taken a Joint Life Policy for Rs. 15,000, the payment for which was received on July 31, 2007. According to the partnership agreement, on retirement or death of partner, the goodwill was to be valued at 1-1/2 times the average profit of the last four years. The profits for the last four years were Rs. 6,000, Rs. 7,500, Rs. 9,000 and Rs. 9,500 respectively. For paying the amount due to A's legal representative, B and C brought as much cash as would bring their capitals in profit-sharing ratio and the firm would have cash in hand Rs. 3,000.

Calculate Goodwill, prepare Partners' Capital Accounts and the Balance Sheet.

Solution:

Calculation of Goodwill

$$\text{Average Profit for four years} = \frac{6,000 + 7,500 + 9,000 + 9,500}{4} = \text{Rs. } 8,000$$

$$\text{Goodwill at } 1\frac{1}{2} \text{ times} = 8,000 \times 1\frac{1}{2} = \text{Rs. } 12,000$$

Less: Existing goodwill Rs. 3,000

Increase in the value of goodwill Rs. 9,000

Calculation of gain in Joint Life Policy

Sum received from insurance Company	15,000
Less: Joint Life Insurance Company	<u>2,000</u>
Net Gain to be distributed amongst the partners	<u>13,000</u>

Partners' Capital Account

Dr.				Cr.			
Particulars	A Rs.	B Rs.	C Rs.	Particulars	A Rs.	B Rs.	C Rs.
To Cash A/c	21,000			By Balance b/d	10,000	6,000	4,000
To A's Capital A/c		2,250	2,250	By B's Capital A/c	2,250		
To Balance c/d		10,000	10,000	By C's Capital A/c	2,250		
				By Joint Life Policy A/c	6,500	3,250	3,250
				By Cash A/c		<u>3,000</u>	<u>5,000</u>
	<u>21,000</u>	<u>12,250</u>	<u>12,250</u>		<u>21,000</u>	<u>12,250</u>	<u>12,250</u>

Calculation of cash brought in by B and C:

	Rs.	Rs.
Amount payable to A's legal representatives		21,000
Add: Desired cash in hand		<u>3,000</u>
Amount required		24,000
Less: Amount received from Insurance company	15,000	
Existing balance of cash in hand	<u>1,000</u>	<u>16,000</u>
Shortage of cash to be brought in By B and C		<u>8,000</u>
B's Capital after adjustment of Goodwill and Life Policy		7,000

C's Capital after adjustment of Goodwill and Life Policy		5,000
Shortage of cash to be brought in		<u>8,000</u>
Total Capital of B and C after A's death		<u>20,000</u>
Share of B being 1/2th of Rs. 20,000	10,000	
Less: Already in the business	<u>7,000</u>	
Cash to be introduced by B	<u>3,000</u>	
Share of C being 1/2 of Rs. 20,000	10,000	
Less: Already in the business	<u>5,000</u>	
Cash to be introduced by C	<u>5,000</u>	

Balance Sheet of B and C

Liabilities	Rs.	Assets	Rs.
Creditors	4,000	Goodwill	3,000
Bills payable	2,000	Freehold Property	10,000
Capitals:		Stock	5,500
B	10,000	Debtors	4,500
C	<u>10,000</u>	Cash	<u>3,000</u>
	<u>20,000</u>		<u>26,000</u>
	<u>26,000</u>		<u>26,000</u>

35. REPAYMENT OF THE AMOUNT DUE TO DECEASED PARTNER

On death of a partner, the amount due his legal representatives will have to be paid. It may not be possible to pay the whole amount in lump sum. As a rule the payment is made according to terms of partnership agreement. The various courses available may be –

- Repayment in instalments over a period of time and interest is paid on outstanding balance.
- The amount due may be treated as a loan to the firm. The firm may pay interest at an agreed rate or share of profit of the firm.
- An annuity may be paid of the life of some dependent.

Illustration 22:

On 31st December, 2006 the balance sheet of Sen, Sil and Som who shared profits and losses in the ratio of 4 : 3 : 2 stood as follows:

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	20,600	Furniture and Fittings	12,000
Joint Life Policy Reserve	6,000	Joint Life Policy	10,000
Capital Accounts		(Policy for Rs. 18,500)	
Sen	10,000	Sundry Debtors	17,500
Sil	30,000	Stock	30,500
Som	<u>10,500</u>	Cash at Bank	<u>7,100</u>
	<u>77,100</u>		<u>77,100</u>

On 31st March, 2007 Sen died. According to Partnership Deed, at the time of death, goodwill of the firm was to be valued at 2 years purchase of average profits of the last three years and deceased partner's capital account was to be credited with the share of profits for the period he

lived in the year of death on the basis of profits of immediately previous year.

Find out the amount due to Sen's executors on 31st March, 2007. Profits for the past three years have been as follows:

For the year ended 31st December, 2006	Rs. 36,000
For the year ended 31st December, 2005	Rs. 30,000
For the year ended 31st December, 2004	Rs. 25,800

Solution:

$$\begin{aligned}\text{Total profits for the past three years} &= \text{Rs. } 36,000 + \text{Rs. } 30,000 + \text{Rs. } 25,800 \\ &= \text{Rs. } 91,800\end{aligned}$$

$$2 \text{ year's purchases of average profit} = \text{Rs. } \frac{91,800}{3} \times 2 = \text{Rs. } 61,200$$

$$\therefore \text{Total Goodwill} = 61,200$$

$$\text{Sen's share} = 61,200 \times \frac{4}{9} = \text{Rs. } 27,200$$

Sen's share of profits for 3 months on the basis of profit for 2006

$$= \text{Rs. } 36,000 \times \frac{4}{9} \times \frac{1}{4} = \text{Rs. } 4,000$$

$$\text{Sen's share in policy} = \text{Rs. } (18,500 + 6,000 - 10,000) \times \frac{4}{9} = \text{Rs. } 6,444$$

Total amount due to Sen's executors

$$= \text{Rs. } 10,000 + \text{Rs. } 27,200 + \text{Rs. } 4,000 + \text{Rs. } 6,444 = \text{Rs. } 47,644.$$

Illustration 23:

Following is the balance sheet of A, B and C as at 1st April, 2007:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry creditors	20,000	Goodwill	40,000
Reserve fund	32,000	Plant and Machinery	60,000
Capital Account:		Stock	40,000
A	1,00,000	Sundry debtors	60,000
B	50,000	Cash at Bank	50,000
C	<u>50,000</u>	Cash in hand	<u>2,000</u>
	<u>2,52,000</u>		<u>2,52,000</u>

C died on 30th June, 2007. Under the terms of partnership deed, the executors of a deceased partner were entitled to –

- Amount standing to the credit of partners' capital account;
- Interest on capital balance at 15% per annum;
- Share or goodwill on the basis of twice the average of the past three years profit; and
- Share of profit from the closing of the last financial year to the date of death on the basis

of the average of the three completed years profits before the death.

Profit for the years ended 31st March, 2005, 2006 and 2007 were Rs. 60,000, Rs. 70,000 and Rs. 80,000 respectively. Profits were shared in the ratio of capitals.

Pass the necessary journal entries and draw up C's Capital Account to be rendered to his executors.

Solution:

Journal Entries

		Rs.	Rs.
Reserve Fund	Dr.	8,000	
To C's Capital A/c			8,000
(Being the share of reserve fund transferred to his capital account)			
Interest on Capital A/c	Dr.	1,875	
To C's Capital A/c			1,875
(Being the interest @ 15% credited to C's Capital Account)			
A's Capital A/c	Dr.	16,667	
B's Capital A/c	Dr.	8,333	
To C's Capital A/c			25,000
(Being the share of goodwill due to C, debited to the capital accounts of existing partners)			
Profit and Loss A/c	Dr.	4,375	
To C's Capital A/c			4,375
(Being the share profit till 30th June, 2007 based on the average profit of the preceding three years credited to C's Capital Account)			

C's Capital Account

Dr.		Cr.	
Rs.		Rs.	
To C's Executor's	89,250	By Balance b/d	50,000
		By Reserve fund	8,000
		By Interest on Capital	1,875
		By A's Capital A/c	16,667
		By B's Capital A/c	8,333
		By Profit and Loss A/c	4,375
	<u>89,250</u>		<u>89,250</u>

Notes : (i) Calculation of Goodwill

Total profit of three years = Rs. 2,10,000

Average Profit = Rs. 2,10,000 ÷ 3 = Rs. 70,000

$$\text{Goodwill} = \text{Rs. } 70,000 \times 2 = \text{Rs. } 1,40,000$$

Existing Goodwill Rs. 40,000

Goodwill to be increased by Rs. 1,00,000

$$\text{C's Share} = \text{Rs. } 1,00,000 \div 4 = \text{Rs. } 25,000$$

(ii) Calculation of C's Share of Profit

Average Profit = Rs. 70,000

$$\text{C's Share for 3 months} = \text{Rs. } 70,000 \times \frac{1}{4} \times \frac{3}{12} = \text{Rs. } 4,375$$

36. DISSOLUTION OF PARTNERSHIP

Dissolution of a firm means that the business of the firm is put to an end, assets are disposed off, liabilities are paid off, and the accounts of all the partners are also settled. Dissolution of a firm differs from dissolution of a partnership. When a partnership is formed for a specified venture, it is dissolved on the expiry of the term or on the completion of the specified venture, but the partners may decide to continue to run the business for another term or for another venture. Similarly, death, retirement or insolvency of a partner dissolves the partnership but the remaining partners may continue to run the business.

Thus, the difference between dissolution of partnership and dissolution of firm may be summarized as under:

- (i) In case of dissolution of firm, the firm ceases to continue its business i.e. the business comes to an end. But in the case of dissolution of partnership, the business of the firm is continued.
- (ii) In dissolution of firm, the partnership among all the partners no longer exists while in case of dissolution of partnership, the partnership among all the partners does not come to an end.
- (iii) Dissolution of partnership does not necessarily mean dissolution of firm whereas dissolution of firm necessarily implies dissolution of partnership.

A firm is dissolved when:

- (i) the partners of the firm decide to dissolve it,
- (ii) all the partners or all the partners except one become insolvent,
- (iii) the business of the firm is declared illegal,
- (iv) in case partnership at will, a partner gives notice of dissolution,
- (v) The Court orders dissolution of the firm which may happen in the following circumstances:
 - (a) where a partner has become of unsound mind,
 - (b) where a partner suffers from permanent incapacity,
 - (c) where a partner is guilty of misconduct affecting the business,
 - (d) where there is persistent disregard of partnership agreement by a partner,
 - (e) where a partner transfers his interest or share to a third person,
 - (f) where a business cannot be carried on except at a loss, and
 - (g) where a dissolution appears to the Court to be just and equitable on any other ground.

37. SETTLEMENT OF ACCOUNTS OF PARTNERS

On dissolution, the assets of the firm are sold out and the proceeds are applied in the following order:

- (1) in paying debts due to third parties.
- (2) in paying rateably the loans advanced by partners to the firm, and
- (3) in paying to the partners the sums due to them on account of capital.

If there is a surplus, it has to be distributed among the partners in the profit sharing ratio. On the other hand, if there is a loss on dissolution, it has to be made up first out of past accumulated profits, then out of capitals of the partners and lastly out of contributions from private estates of the partners in the profit sharing ratio.

An important principle to remember is that the private property of a partner is to be used first to pay his private debts and only the surplus, if any, can be used to pay firm's liabilities. Similarly, firm's assets are first used to pay firm's liabilities. A partner can use only his share of the surplus to pay his private liabilities. Another principle to remember is that the liability of partners is joint and several. It means that if a partner is unable to bring in his share of loss, the other partners have to make up his share of loss also.

38. ACCOUNTING TREATMENT ON DISSOLUTION OF PARTNERSHIP

On dissolution, the books of accounts of the firm are closed. The various steps necessary for the purpose can be described as follows:

1. Open a Realisation Account and transfer to it all the assets except cash in hand and at bank. Sundry Debtors will be transferred at gross amounts. Provision for Bad Debts Account being a separate account.
2. Transfer to Realisation Account all liabilities to outsiders and provisions against assets like Provision for Bad Debts. However, accounts denoting accumulated losses or profits will not be transferred to Realisation Account.
3. Realisation Account will be credited with the actual amount realised by sale of assets. If a partner takes over an asset the capital account of that partner is debited and Realisation Account is credited with the value agreed upon.
4. Actual amount paid to the creditors of the firm is debited to Realisation Account. If a partner takes over a liability, his capital account is credited and Realisation Account is debited with the amount agreed upon.
5. Expenses during the course of dissolution are debited to Realisation Account and credited to cash.
6. Profit or loss revealed by Realisation Account is transferred to all the partners' capital accounts in their profit sharing ratio. Realisation Account is thus closed.
7. Loans advanced by partners to the firm are repaid.
8. Any reserve or accumulated profit or loss lying in the books of accounts is transferred to capital accounts in the profit sharing ratio.
9. Partners whose capital accounts may be showing a debit balance bring cash to clear their accounts.
10. Payment is made to the partners whose capital accounts are showing credit balances. This will close the books of accounts.

Illustration 24:

On 31st March, 2007 the following was the balance sheet of A, B and C when the firm was dissolved:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
--------------------	------------	---------------	------------

Capital Accounts:		Goodwill	10,000	
A	30,000	Plant & Machinery	20,000	
B	30,000	Furniture	8,000	
C	30,000	Investments	10,000	
General Reserve	9,000	Stock	51,060	
B's Loan	5,000	Debtors	23,600	
Mrs. A's Loan	5,000	Less: Provision		
Current Account		for Bad debts	<u>1,020</u>	22,580
A	2,860			
C	1,240	Bill Receivable	5,000	
Bill Payable	10,000	Cash at Bank	2,760	
Sundry Creditors	6,530	Unexpired Insurance	125	
		B's Current Account	<u>105</u>	
	<u>1,29,630</u>			<u>1,29,630</u>

Investments were taken over by A for Rs. 13,000 whereas bills receivable were taken over by B for Rs. 4,800, fixed assets fetched Rs. 17,000 whereas stock realised Rs. 60,000. All the debtors paid the amounts due from them. Total rebate of Rs. 110 was received on retiring all bills payable immediately. Expenses of realisation came to Rs. 1,441.

Pass Journal entries to close the books of the firm and show Realisation Account, Bank Account, and the Capital Accounts of all the partners.

Solution:

Journal Entries

		Dr.	Cr.
		Rs.	Rs.
Realisation Account	Dr.	1,27,785	
To Goodwill			10,000
To Plant and Machinery			20,000
To Furniture			8,000
To Investments			10,000
To Stock			51,060
To Debtors			23,600
To Bills Receivable			5,000
To Unexpired Insurance			125
(Transfer of assets to Realisation Account)			
		Rs.	Rs.
Provision for Bad Debts	Dr.	1,020	
Mrs. A's Loan	Dr.	5,000	
Bills Payable	Dr.	10,000	
Sundry Creditors	Dr.	6,530	
To Realisation Account			22,550
(Transfer of liabilities to outsiders to Realisation Account)			
Note: Mrs. A is also an outsider)			
Bank	Dr.	1,00,600	

To Realisation Account			1,00,600
(Sale proceeds of fixed assets and stock and amount received from debtors)			
A's Current Account	Dr.	13,000	
B's Current Account	Dr.	4,800	
To Realisation Account			17,800
(For investments taken over by A for Rs. 13,000 and bills receivable taken over by B for Rs.4,800)			
Realisation Account	Dr.	21,420	
To Bank			21,420
(Payment made to pay of liabilities to outsiders – Rs. 5,000 to Mrs. A. Rs. 9,890 for bills payable and Rs. 6,530 to Creditors)			
Realisation Account	Dr.	1,441	
To Bank			1,441
(Expenses of realisation amounting Rs. 1,441)			
A's Current Account	Dr.	3,232	
B's Current Account	Dr.	3,232	
C's Current Account	Dr.	3,232	
To Realisation Account			9,696
(Transfer of loss of realisation)			
B's Loan Account	Dr.	5,000	
To Bank			5,000
(Payment of B's loan)			
General Reserve	Dr.	9,000	
To A's Current Account			3,000
To B's Current Account			3,000
To C's Current Account			3,000
(Transfer of General Reserve)			
		Rs.	Rs.
A's Capital Account	Dr.	10,372	
B's Capital Account	Dr.	5,137	
To A's Current Account			10,372
To B's Current Account			5,137
(Transfer of debit balances of current			

accounts of A and B to
their Capital Accounts)

C's Current Account	Dr.	1,008	
To C's Capital Account			1,008

(Transfer of credit balance in C's Current Account to C's Capital Account)

A's Capital Account	Dr.	19,628	
B's Capital Account	Dr.	24,863	
C's Capital Account	Dr.	31,008	
To Bank			75,499

(Payment to Partners)

**Ledger Accounts
Realisation Account**

<i>Dr.</i>			<i>Cr.</i>
	<i>Rs.</i>		<i>Rs.</i>
To Sundry Assets:			
Goodwill	10,000	By Provision for Bad Debts	1,020
Plant and Machinery	20,000	By Mrs. A's Loan	5,000
Furniture	8,000	By Bills Payable	10,000
Investments	10,000	By Sundry Creditors	6,530
Stock	51,060	By Bank	1,00,600
Debtors	23,600	By A's Current Account	
Bills Receivable	5,000	(Investments)	13,000
Unexpired Insurance	125	By B's Current Account	
To Bank (Liabilities)	21,420	(B/R)	4,800
To Bank (Expenses)	1,441	By A's Current Account	
		(1/3rd loss)	3,232
		By B's Current Account	
		(1/3rd loss)	3,232
		By C's Current Account	
		(1/3rd loss)	3,232
	<u>1,50,646</u>		<u>1,50,646</u>

Bank

	<i>Rs.</i>		<i>Rs.</i>
To Balance b/d	2,760	By Realisation (liabilities)	21,420
To Realisation A/c		By Realisation (expenses)	1,441
(Sale proceeds of assets)	1,00,600	By B's Loan Account	5,000
		By A's Capital Account	19,628
		By B's Capital Account	24,863
		By C's Capital Account	31,008
	<u> </u>		<u> </u>

1,03,3601,03,360**Current Accounts**

	A Rs.	B Rs.	C Rs.		A Rs.	B Rs.	C Rs.
To Balance b/d		105		By Balance b/d	2,860		1,240
To Realisation	13,000	4,800		By General Reserve	3,000	3,000	3,000
To Realisation (loss)	3,232	3,232	3,232	By A's Capital	10,372		
To C's Capital	<u>16,232</u>	<u>8,137</u>	<u>1,008</u>	By B's Capital	<u>16,232</u>	<u>5,137</u>	<u>4,240</u>
			<u>4,240</u>			<u>8,137</u>	

Capital Accounts

	A Rs.	B Rs.	C Rs.		A Rs.	B Rs.	C Rs.
To A's Current A/c	10,372			By Balance b/d	30,000	30,000	30,000
To B's Current A/c		5,137		By C's Current A/c			1,008
To Bank	<u>19,628</u>	<u>24,863</u>	<u>31,008</u>		<u>30,000</u>	<u>30,000</u>	<u>31,008</u>
	<u>30,000</u>	<u>30,000</u>	<u>31,008</u>				

There is an alternative approach also. Instead of transferring assets and liabilities to Realisation Account and then recording sale proceeds and payments for liabilities in Realisation Account, sale proceeds and payments for liabilities may be recorded in the respective assets accounts and accounts for liabilities and only the balance left in the accounts be transferred to Realisation Account to close the accounts of assets and liabilities. In other words, only profit or loss on realisation of individual assets and discharge of individual liabilities appear in Realisation Account. Worthless assets, of course, will be transferred to Realisation Account at book value. Expenses of realisation are also debited to Realisation Account. Balance of Realisation Account is transferred to Capital Accounts in profit sharing ratio.

Realisation Account for the previous illustration under this method is shown below:

Realisation Account

Dr.		Cr.	
Rs.		Rs.	
To Fixed Assets (details not given) (Rs. 38,000 – Rs. 17,000)	21,000	By Investments (Rs. 13,000 – Rs. 10,000)	3,000
To Bills Receivable (Rs. 5,000 – Rs. 4,800)	200	By Stock (Rs. 60,000 – Rs. 51,060)	8,940
To Unexpired insurance	125	By Provision for Bad Debts	1,020
To Bank (expenses)	1,441	By Bills Payable	110
		By A's Current Account	3,232
		By B's Current Account	3,232
		By C's Current Account	<u>3,232</u>
	<u>22,766</u>		<u>22,766</u>

Illustration 25:

A, B and C commenced business on 1st April, 2006. They agreed to share the profits and losses in the ratio of 2: 2: 1. Their capitals were Rs. 30,000, Rs. 22,500 and Rs. 15,000 respectively. The partnership deed provided for interest on capital at 6% per annum. During 2006-07 the firm earned a profit of Rs. 20,050 (before providing for interest on capital). During the year the partners' drawings were A – Rs.7,000; B – Rs. 6,250; and C – 4,000.

The relation between partners was not good. They decided to dissolve the firm on 31st March, 2007. The assets were sold which realised Rs. 75,000. There were creditors to the extent of Rs. 12,000 which were paid off at a discount of 5%. Expenses of realisation amounted to Rs. 1,200.

Prepare the necessary accounts to close the books of the firm.

Solution:

Profit and Loss Account					
<i>Dr.</i>			<i>Cr.</i>		
2007		<i>Rs.</i>	2007		<i>Rs.</i>
Mar. 31	To Capital A/c (interest)		Mar. 31	By Net Profit	20,050
	A 1,800				
	B 1,350				
	C <u>900</u>	4,050			
	To Profit transferred to:				
	A 6,400				
	B 6,400				
	C <u>3,200</u>	<u>16,000</u>			
		<u>20,050</u>			<u>20,050</u>

A's Capital Account					
2007		<i>Rs.</i>	2006		<i>Rs.</i>
Mar.31	To Drawings	7,000	Apr. 1	By Cash	30,000
	To Balance c/d	31,200	2007		
			Mar.31	By Profit & Loss A/c (interest)	1,800
				By Profit & Loss A/c (share of profit)	<u>6,400</u>
		<u>38,200</u>			<u>38,200</u>
2007		<i>Rs.</i>	2007		<i>Rs.</i>
Mar. 31	To Realisation (loss)	3,160	Mar. 31	By Balance b/d	31,200
	To Cash A/c	<u>28,040</u>			
		<u>31,200</u>			<u>31,200</u>

B's Capital Account					
2007		<i>Rs.</i>	2006		<i>Rs.</i>
Mar. 31	To Drawings	6,250	Apr. 1	By Cash	22,500
	To Balance c/d	24,000	2007		
			Mar. 31	By Profit & Loss A/c (interest)	1,350
				By Profit & Loss A/c (share of profit)	<u>6,400</u>
		<u>30,250</u>			<u>30,250</u>

2007				2007		
Mar. 31	To	Realisation (loss)	3,160	Mar. 31	By	Balance b/d
	To	Cash A/c	<u>20,840</u>			<u>24,000</u>
			<u>24,000</u>			<u>24,000</u>

C's Capital Account

2007			Rs.	2006		Rs.
Mar. 31	To	Drawings	4,000	Apr. 1	By	Cash
	To	Balance b/d	15,100	2007		15,000
				Mar. 31	By	Profit & Loss A/c (interest)
						900
					By	Profit & Loss A/c (share of profit)
						<u>3,200</u>
			<u>19,100</u>			<u>19,100</u>
2007				2007		
Mar. 31	To	Realisation (loss)	1,580	Mar. 31	By	Balance b/d
	To	Cash A/c	<u>13,520</u>			15,100
			<u>15,100</u>			<u>15,100</u>

Balance Sheet as at 31st March, 2007

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	12,000	Sundry Assets	82,300
Capital A/cs:			
A	31,200		
B	24,000		
C	<u>15,100</u>		
	<u>70,300</u>		
	<u>82,300</u>		<u>82,300</u>

Realisation Account

2007			Rs.	2007		Rs.
Mar. 31	To	Sundry Assets	82,300	Mar. 31	By	Sundry Creditors
	To	Cash (expenses)	1,200		By	Cash
	To	Cash (creditors Rs. 12,000 less 5%)	11,400			(assets realised)
					By	Loss transferred to:
						A – 3,160
						B – 3,160
						C – <u>1,580</u>
			<u>94,900</u>			<u>7,900</u>
						<u>94,900</u>

Cash Account

2007			Rs.	2007		Rs.
Mar. 31	To	Realisation A/c (assets realised)	75,000	Mar. 31	By	Realisation (expenses)
					By	Realisation A/c (creditors)
						11,400
					By	Capital A/cs:
						A – 28,040
						B – 20,840

75,000

C – 13,520

62,400
75,000

39. DISTINCTION BETWEEN REVALUATION ACCOUNT AND REALISATION ACCOUNT

The following are the points of distinction between revaluation account and realisation account:

<i>Revaluation Account</i>		<i>Realisation Account</i>
(1)	(2)	(3)
(i)	The effect of the revaluation of assets and liabilities are recorded in revaluation account	It records the sale of various assets and payment of liabilities
(ii)	Revaluation account is prepared at the time of reconstitution of the firm	It is prepared only at the time of dissolution of the firm
(1)	(2)	(3)
(iii)	Revaluation account is prepared to find out the profit (loss) on the revaluation of assets and liabilities	Realisation account is prepared to find out the profit (loss) on the realization of assets and settlement of liabilities
(iv)	It contains only those assets and liabilities which are revalued	It contains generally all assets and liabilities
(v)	The balance of this account is transferred to the old partners' capital accounts	The balance of this account is transferred to the capital accounts of all partners
(vi)	Accounting entries are made on the basis of the difference between book value and revalued figures	Accounting entries are made at the book value of assets and liabilities
(vii)	On revaluation, the accounts of assets and liabilities are not closed	The accounts of assets and liabilities are closed on preparation of realization account

40. RETURN OF PREMIUM ON DISSOLUTION

If a partner on his admission pays to the other partner an amount for goodwill (also known as premium) and it is agreed that the partnership would be for a fixed term, then, if the firm is dissolved before the expiry of such a term, the partner will be entitled to a refund of a rateable amount of the premium so paid. Suppose A and B admit C as a new partner on the condition that C pays Rs. 10,000 for goodwill and it is agreed that the partnership would be for 10 years. But if the firm is dissolved after 4 years, C will be entitled to a refund of Rs. 6,000 depending upon the circumstances.

However, such a refund cannot be claimed under the following conditions:

- (i) When the firm is dissolved due to the death of a partner.
- (ii) When the dissolution takes place mainly due to the misconduct of the partner making the claim, or
- (iii) Where the dissolution is in pursuance of an agreement that no such refund will be made.

41. INSOLVENCY OF A PARTNER

In dissolution, if the capital account of a partner shows a debit balance, he will have to pay the amount to the firm. But if he is insolvent, he will not be able to do so; at any rate he will not be able to pay the full amount of such a debit balance. The sum which becomes irrecoverable from a partner due to his insolvency is also a loss to be born by other partners. Before the decision in *Garner v. Murray* case was made, such a loss used to be treated as an ordinary loss and transferred to the capital accounts of the solvent partners in their relative profit sharing ratio. But decision in *Garner v. Murray* has changed the position.

42. DECISION IN *GARNER V. MURRAY*

According to the decision in *Garner v. Murray*, in case of insolvency of a partner:

- (a) first the solvent partners should bring in cash equal to their share of the loss on realisation, and
- (b) then, the loss due to the insolvency of a partner should be divided among the other partners in the ratio of capitals standing after partners have brought in cash equal to their share of loss on realisation.

The effect of this decision is that the deficiency in the capital account of the insolvent partner has to be borne by the solvent partners in the ratio of capitals standing just prior to dissolution. The fact of capitals being fixed or fluctuating assumes great significance in such a situation. If the capitals are fixed, then the loss due to the insolvency of a partner will be borne by the solvent partners in the ratio of their capitals. But if the capitals are fluctuating, all necessary adjustments in respect of reserves or profit and loss account are first made (but the loss on realisation is not adjusted) in the capital accounts of all the partners, and then the debit balance of the capital account of the insolvent partner is transferred to the capital accounts of the solvent partners in the ratio of their capitals now standing.

Note: It is noteworthy that, if on the date of dissolution, a partner had no credit balance in his capital account, he will not bear any loss on account of insolvency of another partner. This is irrespective of his private wealth.

Illustration 26:

On 31st March, 2007 the following was the balance sheet of A, B and C who share profits and losses in the ratio of 2:1:1 respectively.

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Creditors	16,000	Cash in hand	200
General Reserve	5,000	Stock	18,800
Capital Accounts		Debtors	11,300
A	30,000	Furniture	12,500
B	20,000	Plant & Machinery	20,000
C	<u>1,000</u>	Goodwill	<u>9,200</u>
	<u>72,000</u>		<u>72,000</u>

The firm was dissolved on this date due to C's insolvency. Assets realised Rs.32,000. Expenses of dissolution came to Rs. 200. C's estate paid 50% of what was due to C.

Close the books of the firm assuming that the loss due to insolvency has been divided:

- (i) in the ratio of fixed capital
- (ii) in the ratio of fluctuating capital.

Solution:

(i) Loss due to Deficiency is divided in the Ratio of Fixed Capital Accounts

Realisation Account			
Dr.			Cr.
	Rs.		Rs.
To Stock	18,800	By Creditors	16,000
To Debtors	11,300	By Cash (Assets)	32,000
To Furniture	12,500	By A's Capital Account	20,000
To Plant & Machinery	20,000	By B's Capital Account	10,000
To Goodwill	9,200	By C's Capital Account	10,000
To Cash (Creditors)	16,000		
To Cash (Expenses)	200		
	<u>88,000</u>		<u>88,000</u>

Capital Accounts							
	A Rs.	B Rs.	C Rs.		A Rs.	B Rs.	C Rs.
To Realisation A/c	20,000	10,000	10,000	By Balance b/d	30,000	20,000	1,000
To C's Capital A/c	2,325	1,550		By General Reserve	2,500	1,250	1,250
To Cash A/c	30,175	19,700		By Cash A/c	20,000	10,000	3,875
				By A's Cap. (3/5)			2,325
				By B's Cap. (2/5)			<u>1,550</u>
	<u>52,500</u>	<u>31,250</u>	<u>10,000</u>		<u>52,500</u>	<u>31,250</u>	<u>10,000</u>

Cash Account			
	Rs.		Rs.
To Balance b/d	200	By Realisation A/c (creditors)	16,000
To Realisation A/c (assets)	32,000	By Realisation A/c (expenses)	200
To A's Capital Account	20,000	By A's Capital Account	30,175
To B's Capital Account	10,000	By B's Capital Account	19,700
To C's Capital Account	<u>3,875</u>		
	<u>66,075</u>		<u>66,075</u>

Note : Since Current Accounts have not been specified in the question the adjustments have been made in Capital Accounts.

(ii) Loss due to Deficiency is divided in the Ratio of Fluctuating Capital Accounts

Realisation Account will be the same as in the case (i)

Capital Accounts							
	A Rs.	B Rs.	C Rs.		A Rs.	B Rs.	C Rs.
To Realisation A/c	20,000	10,000	10,000	By Balance b/d	30,000	20,000	1,000
To C's Capital A/c	2,343	1,532		By Gen. Res.	2,500	1,250	1,250

To	Cash A/c	30,157	19,718	By	Cash A/c	20,000	10,000	3,875
				By	A's Capital A/c			
					(26/43ths share)			2,343
				By	B's Capital A/c			
					(17/43ths share)			1,532
		<u>52,500</u>	<u>31,250</u>			<u>52,500</u>	<u>31,250</u>	<u>10,000</u>

Balances in A's Capital Account and B's Capital Account after adjustment for General Reserve are Rs. 32,500 and Rs. 21,250 respectively. Hence, A and B will bear the loss of Rs. 3,875 due to C's insolvency in the ratio of 32,500 : 21,250 or 26 : 17 respectively.

$$\text{A's share} = \text{Rs. } 3,875 \times \frac{26}{43} = \text{Rs. } 2,343$$

$$\text{B's share} = \text{Rs. } 3,875 \times \frac{17}{43} = \text{Rs. } 1,532$$

Dr.	Cash Account		Cr.
	Rs.		Rs.
To Balance b/d	200	By Realisation A/c (Creditors)	16,000
To Realisation A/c (Assets)	32,000	By Realisation A/c (Expenses)	200
To A's Capital Account	20,000	By A's Capital Account	30,157
To B's Capital Account	10,000	By B's Capital Account	19,718
To C's Capital Account	3,875		
	<u>66,075</u>		<u>66,075</u>

Illustration 27:

A, B, C and D are partners in a firm sharing profits and losses in the ratio of 4 : 1 : 2 : 3. The following is the balance sheet as at March 31st, 2007.

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Sundry creditors		30,000	Cash in hand		14,000
Capital A/cs:			Sundry debtors	35,000	
A	70,000		Less: Provision	<u>5,000</u>	30,000
D	<u>30,000</u>	1,00,000	Other assets		51,000
			Capital A/cs:		
			B	20,000	
			C	<u>15,000</u>	35,000
				<u>1,30,000</u>	<u>1,30,000</u>

On March 31st, 2007, the firm is dissolved. The partnership agreement provides that the deficiency of an insolvent partner will be borne by the solvent partners in the ratio of capitals as they stand just before dissolution.

The following arrangements are agreed upon:

- A is to take over 60% of book debts at 70% and D is to take over the balance at 75%. Further, they are to be allowed Rs. 2,100 and 1,100 respectively to cover future losses.
- D is to realise other assets and to pay off the creditors. He is to receive 5% gross commission on the amounts finally payable to other partners but to bear expenses of realisation. He reports the results of realisation as follows:

Other assets realised at a loss of 2% on net collection and pays of the creditors at a discount of 30%. Realisation expenses amount to Rs. 3,000 but the same is paid by the firm.

B is declared insolvent and a dividend of 20% in a rupee is realised from his estate.

Prepare Cash account, Realisation Account and Capital Accounts.

Solution:

Cash Account			
<i>Dr.</i>	<i>Rs.</i>		<i>Cr.</i>
			<i>Rs.</i>
To Balance b/d	14,000	By Realisation A/c	
To Realisation A/c	50,000	(payment to creditors)	21,000
To B's Capital A/c		By D's Capital A/c (expenses)	3,000
(20% dividend)	4,000	By A's Capital A/c	44,000
To C's Capital A/c	15,000	By D's Capital A/c	15,000
	<u>83,000</u>		<u>83,000</u>

Realisation Account			
	<i>Rs.</i>		<i>Rs.</i>
To Debtors	35,000	By Provision for bad debts	5,000
To Other assets	51,000	By Sundry creditors	30,000
To Cash A/c		By Cash A/c (realisation	
(30,000 – 9,000)		of other assets)	50,000
(payment to creditors)	21,000	By A's Capital A/c	
		(debtors taken over)	12,600
		By D's Capital A/c	
		(debtors taken over)	9,400
	<u>1,07,000</u>		<u>1,07,000</u>

A's Capital Account			
	<i>Rs.</i>		<i>Rs.</i>
To Realisation A/c		By Balance b/d	70,000
(debtors taken over)	12,600		
To B's Capital A/c			
(deficiency)	11,200		
To D's Capital A/c			
(commission)	2,200		
To Cash A/c			
(final payment)	44,000		
	<u>70,000</u>		<u>70,000</u>

B's Capital Account			
	<i>Rs.</i>		<i>Rs.</i>
To Balance b/d	20,000	By Cash A/c	4,000
		By A's Capital A/c	
		(7/10ths deficiency)	11,200
		By D's Capital A/c	
		(3/10ths deficiency)	4,800
	<u>20,000</u>		<u>20,000</u>

C's Capital Account

	Rs.		Rs.
To Balance b/d	15,000	By Cash A/c	15,000
	<u>15,000</u>		<u>15,000</u>

D's Capital Account

	Rs.		Rs.
To Realisation A/c		By Balance b/d	30,000
(debtors taken over)	9,400	By A's Capital A/c	
To Cash A/c (expenses)	3,000	(commission)	2,200
To B's Capital A/c (deficiency)	4,800		
To Cash A/c (final payment)	15,000		
	<u>32,200</u>		<u>32,200</u>

Working Notes:

Sundry Debtors taken over by A:

Rs. 35,000 × 60% × 70%	=	Rs. 14,700
Less: Allowance for further loss	=	<u>Rs. 2,100</u>
		<u>Rs. 12,600</u>

Sundry Debtors taken over by D:

Rs. 35,000 × 40% × 75%	=	Rs. 10,500
Less : Allowance for further loss	=	<u>Rs. 1,100</u>
		<u>Rs. 9,400</u>

D's Commission

Gross amount payable	Rs. 46,200
Commission $\frac{5}{105} \times 46,200$	<u>Rs. 2,200</u>

43. INSOLVENCY OF ALL PARTNERS

If all the partners become insolvent, creditors will not be able to get their amounts in full. All the cash available together with whatever can be received from the private estate of the partners will be paid to the creditors after the expenses of realisation have been met. In case of insolvency of all the partners, creditors should not be transferred to Realisation Account; only assets should be transferred to this Account. Amount realised from assets should be credited to Realisation Account. Expenses should be debited to Realisation Account. Now the balance in Realisation Account should be transferred to the Capital Accounts in profit sharing ratio. Now Cash Account should be prepared. After recording the amounts which are received from the estate of the partners the entire cash should be distributed among the creditors rateably. The balances in the accounts of creditors and in the capital accounts should be transferred to Deficiency Account. Thus all the accounts will be closed.

Illustration 28:

Below is the Balance Sheet of C, D and E as on 31st March, 2007

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	2,00,000	Cash	31,200

Loan	1,00,000	Stock	1,56,300
Capital Accounts		Debtors	47,200
C	80,000	Furniture	95,300
D	60,000	Profit & Loss Account	1,20,000
E	<u>10,000</u>		<u> </u>
	<u>1,50,000</u>		<u> </u>
	<u>4,50,000</u>		<u>4,50,000</u>

The firm was dissolved due to insolvency of all the partners. Stock was sold for Rs. 1,09,000 while furniture fetched Rs. 40,000. Rs. 41,000 was received from Debtors. Expenses were Rs. 2,200.

Nothing could be recovered from D and E but C's private estate showed a surplus of Rs. 6,000.

Close the books of the firm.

Solution:

Realisation Account

Dr.		Cr.	
	Rs.		Rs.
To Stock	1,56,300	By Cash A/c (assets)	1,90,000
To Debtors	47,200	By C's Capital A/c	37,000
To Furniture	95,300	By D's Capital A/c	37,000
To Cash A/c (expenses)	2,200	By E's Capital A/c	37,000
	<u>3,01,000</u>		<u>3,01,000</u>

Capital Account

	C Rs.	D Rs.	E Rs.		C Rs.	D Rs.	E Rs.
To Profit and Loss A/c - Transfer	40,000	40,000	40,000	By Balance b/d	80,000	60,000	10,000
To Realisation A/c (Loss)	37,000	37,000	37,000	By Cash A/c	6,000		
To Deficiency A/c	9,000			By Deficiency A/c		17,000	67,000
	<u>86,000</u>	<u>77,000</u>	<u>77,000</u>		<u>86,000</u>	<u>77,000</u>	<u>77,000</u>

Cash Account

	Rs.		Rs.
To Balance b/d	31,200	By Realisation A/c (expenses)	2,200
To Realisation A/c (assets)	1,90,000	By Loan A/c	75,000
To C's Capital Account	6,000	By Sundry Creditors	1,50,000
	<u>2,27,200</u>		<u>2,27,200</u>

Loan Account

	Rs.		Rs.
To Cash A/c	75,000	By Balance b/d	1,00,000

To Deficiency A/c	25,000	
	<u>1,00,000</u>	<u>1,00,000</u>

Sundry Creditors

	<i>Rs.</i>		<i>Rs.</i>
To Cash A/c	1,50,000	By Balance b/d	2,00,000
To Deficiency A/c	<u>50,000</u>		
	<u>2,00,000</u>		<u>2,00,000</u>

Deficiency Account

	<i>Rs.</i>		<i>Rs.</i>
To D's Capital Account	17,000	By Loan Account	25,000
To E's Capital Account	67,000	By Sundry Creditors	50,000
		By C's Capital	<u>9,000</u>
	<u>84,000</u>		<u>84,000</u>

SELF-TEST QUESTIONS

1. What is meant by partnership?
2. What is partnership deed?
3. Distinguish between fluctuating and fixed capital accounts.
4. Why is interest allowed on capital?
5. Why is interest charged on drawings? How is it calculated?
6. State which of the following statements are false?
 - (i) There can be a partnership between two chartered accountants.
 - (ii) At the most there can be fifty partners in a firm.
 - (iii) In every partnership, there must be a partnership deed.
 - (iv) Unless provided otherwise, partners are deemed to be sharing profits and losses in the ratio of their capitals.
 - (v) The amount of cash brought in by a new partner by way of goodwill is credited to old partners in their old sharing ratio.

(Ans.: All statements except (i) are false)

7. What is goodwill? In what ways can it be treated on admission of a partner?
8. Why are adjustments in the values of assets and liabilities made on the admission of partner?
9. On 1st April 2006 X's Capital Account showed a balance of Rs. 50,000 while Y's Capital Account showed a balance of Rs. 20,000. In 2006-07 the firm earned a profit of Rs. 30,000 before adjustment for salary to Y amounting to Rs. 6,000 for the year and interest on capital @ 7% per annum. Show how the profits would be distributed between X and Y assuming that they are equal partners.
 (Ans. : X would get in all Rs. 13,050 whereas Y would get Rs. 16,950)
10. P, a partner withdraws the following sums during 2007:

On 1st February	Rs. 1,000
On 1st May	Rs. 3,000
On 1st October	Rs. 2,000

On 1st December

Rs. 1,000

Calculate interest on his drawing @6% per annum. (Ans.: Rs. 210)

11. On 1st April, 2007 A and B who sharing profits and losses in the ratio of 3:2 decided to become equal partners with effect from 1st April, 2006 with the additional provision that interest on capitals will be allowed @7% per annum. A and B started the firm on 1st April, 2006 with a capital of Rs. 30,000 and Rs. 20,000 respectively. The profit for the year ended 31st March, 2007 amounted to Rs. 18,000.

Pass the necessary adjustment entry.

(Ans.: Debit A and Credit B with Rs. 1,450)

12. On the admission of a new partner, it is decided that goodwill of the firm be calculated at 2 years purchase of average profits for the past three years which amounted to Rs. 8,620, Rs. 9,430 and Rs. 11,800 respectively.

What is the value of goodwill?

(Ans.: Rs. 19,900)

13. X and Y are sharing profits and losses in the ratio of 7:4. They admit Z as new partner and the new profit sharing ratio is agreed upon to be $X \frac{5}{11}$, $Y \frac{3}{11}$ and $Z \frac{3}{11}$. Z brings in Rs. 20,000 by way of his share of goodwill. How will this amount be distributed between X and Y?

[Ans.: X will be credited with Rs. 13,333 and Y will be credited with Rs. 6,667]

14. P and Q are equal partners. R is admitted as a new partner and he is given 1/5th share in the profit of the firm. What will be the new profit sharing ratio?

(Ans.: 2:2:1)

15. Fill in the blanks:

- (i) If partnership deed is silent on the profit sharing ratio; interest @..... per annum is allowed on loans advanced by partners.
- (ii) If a new partner purchases his share from other partners, the total assets of the firm.....
- (iii) In case values of assets and liabilities are not to be altered on admission of a partner but effect of each change has to be recorded, a..... Revaluation Account is opened.
- (iv) At the most there can be partners in a banking business and..... partners in any other business.

(Ans. : (i) 6%, (ii) do not change, (iii) Memorandum, (iv) 10,20)

16. On 1st March, 2007 the following was the balance sheet of A and B who were carrying on business in partnership sharing profits and losses in the ratio of 3:2 respectively:

Liabilities		Rs.	Assets	Rs.
Capital Accounts			Goodwill	5,000
A	18,000		Machinery	20,000
B	<u>14,000</u>	32,000	Furniture	10,000
General Reserve		9,000	Debtors	10,000
Sundry Trade Creditors		19,700	Less: Provision for	
Bank Overdraft		<u>6,100</u>	Bad Debts	<u>500</u>
		<u>66,800</u>	Stock	<u>22,300</u>
				<u>66,800</u>

C was admitted to the firm on this date on the following terms:

- (i) C would get 1/5th share of future profits.
- (ii) C would bring Rs. 3,000 by way of his share of Goodwill and Rs. 15,000 as capital.

- (iii) Provision for bad debts would be reduced to Rs. 350.
- (iv) Goodwill would appear at its existing value.
- (v) Capitals of the partners would be in their profit sharing ratio; A and B bringing in cash or withdrawing cash as need be.

Pass journal entries, show the important ledger accounts and prepare Balance sheet as it would appear immediately after C' admission.

17. What are the accounting adjustments necessary at the time of retirement of a partner?
18. Following is the balance sheet of A and B (sharing profit and losses in the ratio of 3:2: on 31st March, 2007:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Outstanding Expenses	500	Goodwill	20,000
Creditors	13,600	Plant and Machinery	18,500
8% Loan	20,000	Furniture and Fittings	6,700
Capital Accounts:		Stock	24,600
A	30,000	Debtors	9,350
B	<u>20,000</u>	Cash at Bank	<u>4,950</u>
	<u>84,100</u>		<u>84,100</u>

A retires on that date. Goodwill is valued at Rs. 25,000. It is also agreed that plant and machinery be depreciated by 10% and provision for bad debts amounting to Rs. 150 be made. A new partner name C is admitted who buys one half of A's share, B buying the remaining half share. Find out the amount brought in by C and prepare the initial balance sheet of B and C.

19. (a) P, Q and R, partners sharing profits and losses in the ratio of 7:4:3 respectively. On 31st March, 2007 Q retires and P and R decide to become equal partners. Goodwill of the firm is valued at Rs. 28,000. What adjustment will you make if no Goodwill Account is to be opened and none already exist.

(Ans. : Debit R and Credit Q with Rs. 8,000).

- (b) What will be the entry in (a) above if Goodwill Account already appears at Rs. 21,000 and it is desired that Goodwill Account be allowed to show the same balance?

(Ans.: Debit R and Credit Q with Rs. 2,000).

20. X, Y and Z were partners sharing profits and losses in the ratio of 2:1:1. 1st January, 2004 they took out a joint life policy Rs. 50,000 paying Rs. 2,500 as annual premium. The surrender values of the policy were as follows:

	<i>Rs.</i>
In 2004	Nil
In 2005	1,000
In 2006	2,500
In 2007	4,200

On 20th December, 2007 X died.

Prepare ledger accounts for the entire period (assuming that the firm closes its books on 31st December every year) when:

- (i) Premium was treated as an expense.
- (ii) Joint Life Policy was maintained at its surrender value.
- (iii) Premium was credited to Joint Life Policy Account and adjustments were made in Joint Life Policy Reserve Account for the difference between premium paid and surrender value.

21. **Balance Sheet C, D and E as on 31st December, 2006**

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital Account		Fixed Assets :	
C	50,000	Goodwill	25,000
D	30,000	Plant and Machinery	30,000
E	20,000	Furniture	10,000
Current Accounts		Current Assets:	
D	1,500	Investments	15,000
E	1,300	Stock	40,000
Current liabilities		Debtors	8,000
Trade Creditors	16,250	Cash in hand	500
Bills payable	10,000	Current Account	
Outstanding Expenses	<u>350</u>	C	<u>900</u>
	<u>1,29,400</u>		<u>1,29,400</u>

C died on 30th September, 2007 by which date he had withdrawn Rs. 8,500. Partnership deed provided that in case of death of a partner, in addition to the amount standing to the credit of capital and current accounts of such a partner, the executors will also be titled to a share of the profits from the closing of the last accounting year to the date of death on the basis of the last year's profits. It also provided that goodwill of the firm in case of death of a partner should be revalued at 2 years' purchase of the average profits of the last three years. Profits for 2004, 2005, and 2006 were Rs. 37,500, Rs. 45,800 and Rs. 37,700 respectively.

Investments were sold for Rs. 24,000 net at the stock exchange to pay immediately to C's executors for one-third of the total amount due to them.

Find out the balance left in C's Executors Account? Calculations may be made to the nearest rupee.

(Hints: Profit on sale of investment will be shared by the executors also since it is due to appreciation in the value of assets within the life time of C.

22. Mahesh, Ramesh and Dinesh were sharing profits and losses in the ratio of 3:2:1 respectively. On 31st March, 2007 Ramesh decides to retire. Mahesh agrees to purchase 1/3rd Ramesh's share while Dinesh purchases the balance of Ramesh's share. Find out the new profit sharing ratio between Mahesh and Dinesh.

(Ans. : 11:7)

23. What is the significance of purchase of share of a retiring partner by the remaining partners?

24. A, B and C were carrying on business in partnership sharing profit and losses in the ratio 3:2:1 respectively. On 31st March, 2007 balance sheet of the firm stood as follows:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Bills Payable	15,000	Cash at Bank	8,900
Sundry Creditors	18,340	Creditors	8,000
Capital Accounts		Stock	23,440
A	15,000	Furniture	5,000
B	10,000	Buildings	23,000
C	<u>10,000</u>		
	<u>35,000</u>		
	<u>68,340</u>		<u>68,340</u>

B retired on the above mentioned date on the following terms:

- (i) Buildings be appreciated by Rs. 7,000.
- (ii) Provision for bad debts be made @ 5% on debtors.
- (iii) Goodwill of the firm be valued @ Rs. 9,000 and adjustment in this respect be made without raising Goodwill Account.
- (iv) Rs. 7,000 be paid to B immediately and the balance due to him be treated as a loan carrying interest @ 6% per annum.

Pass journal entries to record the above mentioned transactions and show the balance sheet of the firm as it would appear immediately after B's retirement.

25. What is dissolution of a firm? How does it differ from dissolution of a partnership?
26. When is a firm dissolved?
27. When may the Court order dissolution of a firm?
28. On dissolution of a firm in what order are payments made to creditors and partners?
29. What is *Garner v. Murray* rule? What is its effect in case of insolvency of a partner? Will it make any difference if capital accounts of the partners are fixed or fluctuating?
30. How does insolvency of all the partners of a firm affect the creditors of the firm?
31. (a) C on his admission paid Rs. 20,000 for goodwill on the condition that partnership will be for 10 years. But after only 3 years, the firm has to be dissolved due to misconduct of B, an old partner. Will C be entitled to get refund of the amount paid by him by way of goodwill?

(Ans. : Yes, but only Rs. 14,000)

- (b) Will it make any difference if the firm is dissolved due to misconduct of C himself?

(Ans.: Yes, C won't get anything)

- (c) What will be the position if the partnership firm has to be dissolved due to B's death?

(Ans.: C will not be entitled to get anything by way of
return of amount paid by him as goodwill)

32. A, B and C were equal partners. On 31st March, 2007 their balance sheet stood as follows:

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	1,80,000	Cash in hand	10,000
General Reserve	60,000	Debtors	1,25,000
A's Capital Account	1,80,000	Stock	1,85,000
B's Capital Account	80,000	Furniture	1,04,000
		C's Capital Account	
		– overdrawn	76,000
	<u>5,00,000</u>		<u>5,00,000</u>

On this date the firm was dissolved due to C's insolvency. Only Rs. 1,17,000 could be realised from Debtors while Stock and Furniture fetched Rs. 1,16,800 and Rs. 80,000 respectively. Expenses came to Rs. 1,800. C's estate could pay only 50% of what was due from C.

Show Realisation Account and the accounts of the partners. Assume the capitals are fluctuating. Apply *Garner v. Murray* rule.

33. Following is balance sheet of C and D, two equal partners:

Balance Sheet as on 31st March, 2007

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry Creditors	1,00,000	Sundry Assets	1,07,000
C's Capital Account	50,000	Cash	5,000
		D's Capital Account	
		– overdrawn	38,000
	<u>1,50,000</u>		<u>1,50,000</u>

The firm is dissolved on this date due to the insolvency of both the partners. Sundry Assets realized for Rs. 42,000. Expenses came to Rs. 1,500. C is able to bring Rs. 1,000 while nothing is received from D's private estate.

Close the books of the firm.

Suggested Readings :

- (1) *M.C. Shukla, T.S. Grewal & S.C. Gupta* – Advanced Accounts – Vol. 1
 - (2) *S.N. Maheshwari* – Financial Accounting
 - (3) *J.R. Monga* – Advanced Financial Accounting
 - (4) *R L Gupta & V K Gupta* – Financial Accounting
 - (5) *S.P. Jain & K.L. Narang* – Financial Accounting
-

STUDY XII

INSURANCE CLAIMS

1. INTRODUCTION

Insurance contracts are contracts of indemnity whereby one party, called the insurer, undertakes to indemnify the loss suffered by the other party, called the insured, on the happening of some unforeseen event in consideration of a fixed sum of money, called the premium. The liability of the insurer to indemnify the loss suffered by the insured arises only on the happening of the event for which the policy is taken out. But the liability of the insurer is limited to the amount of loss actually suffered by the insured or the policy amount, whichever is less. In case of under-insurance, the liability of the insurer is limited to the extent of coverage only.

In the event of loss being sustained by the insured in respect of the subject matter insured, the insurance company should be notified of such loss and a claim for indemnity should be lodged in respect of the loss. The insurance company usually employs skilled persons, known as loss assessors or surveyors or inspectors, to investigate the circumstances leading to the loss

suffered and to determine the extent of the damage or loss. The assessors or inspectors carry out their investigation by inspecting the spot where the damage has occurred and relevant books, papers and accounts of the claimants. They also seek information from employees and others who may be able to throw some light on the causes of the damage or loss. On completing their investigation, the assessors or inspectors submit a report to the insurance company giving their considered opinion as to whether the circumstances come within the scope of the policy. They also state their estimate of the extent and value of the damage or loss and the insurance company's corresponding liability.

The insured may agree to accept the amount of the claim estimated by the assessors or inspectors or he may refuse to accept the same. In case he refuses to accept the amount of the claim so estimated by the assessors or inspectors, he may seek to have the claim determined by

- (a) arbitration, or
- (b) legal action on the policy.

Now let us see how claims are determined under various types of policies.

2. CLAIMS UNDER FIRE INSURANCE POLICIES

Fire insurance policies are generally taken to cover the following types of risks:

- (i) Loss of stock in trade.
- (ii) Loss of sundry fixed assets, such as, building, furniture, machinery etc.
- (iii) Loss of profit that may arise due to dislocation caused by fire.

3. SOME IMPORTANT TERMS IN CONNECTION WITH THE FIRE INSURANCE POLICIES

- (1) *Amount of Indemnity* - The policy always specifies the amount upto which the insurers undertake to make good any damage. It should be noted that fire policies are essentially contracts of indemnity aiming to restore the insured to his original position and no further. In no case the insured can make a profit out of a fire. As such, the amount of claim will be limited to the actual loss sustained by the insured, even though the insured value of the property is higher.
- (2) *Period of Indemnity* - The contemplated period of dislocation of a business in consequence of a fire for which the insurance is effected is called the period of indemnity. The length of the period varies with the nature of the business and the delay anticipated in obtaining new machinery, equipment, etc. The longer the period of indemnity for which cover is required, the greater will be the amount of the premium charged. Generally, the period of indemnity does not exceed one year. The period of indemnity starts with the occurrence of fire and ends not later than twelve months thereafter.
- (3) *Insurable Interest* - In all contracts of insurance, it is necessary for the insured to have an insurable interest in the subject matter of insurance. In case of fire insurance, this interest must be continuous, i.e., it must be in existence at the time the policy is taken out and continued and be present when the loss occurs. The insured has an insurable interest in property where he benefits from its preservation and is prejudiced by its destruction. But only pecuniary interest is recognised.
- (4) *Average Clause* - This is a clause which is usually but not necessarily included in fire policies. Average clause is applicable only where the insured has underinsured, i.e., where he has not taken sufficient insurance to cover the value of the property insured. The effect of average clause is that if the actual value of the property is greater than the insured value of the property (i.e., the amount of policy), the insurer will be liable only for that proportion of the loss which the insured value bears to the actual value of the property insured. In such case, the amount of claim of the insured would be based on

the following formula:

$$\text{Claim} = \text{Loss suffered} \times \frac{\text{Sum insured}}{\text{Actual insurable value (Actual Value of Stock)}}$$

For example, if, a property of Rs. 3,00,000 is insured for Rs. 2,00,000 and the loss amounts to Rs. 1,50,000 the amount of claim will be determined as follows:

$$\text{Rs. 1,50,000} \times \frac{\text{Rs. 2,00,000}}{\text{Rs. 3,00,000}} = \text{Rs. 1,00,000}$$

If the property is totally destroyed, the average clause will not be applicable as the same will have no effect at all. In such a case, the amount of claim will be restricted to the sum insured, i.e., Rs. 2,00,000.

4. CLAIMS FOR LOSS OF STOCK

While formulating a claim to loss of stock, the following principles should be borne in mind:

(i) *Where proper stock records are maintained and such records are not destroyed by fire:* In such a case, no difficulty is faced in determining the value of the stock as at the date of fire and the amount of claim. In the first instance, the amount of stock lost by fire has to be ascertained by deducting the value of stock saved or salvaged, if any, from the value of the stock as at the date of fire. Then the average clause, if applicable, has to be applied to determine the amount of claim.

(ii) *Where proper records are not maintained or such records are destroyed by fire:* In such a case, although it is difficult to determine the exact value of stock as at the date of fire, fairly reasonable estimate of the same can be made. The usual method of ascertaining the estimated value of stock as at the date of fire is to prepare an estimated Trading Account for the period since the last accounts were drawn up till the date of fire. For this purpose the following factors should be taken into consideration —

(a) To determine the estimated value of stock as at the date of fire, the ratio or percentage of gross profit to turnover or sales is the most important guide. In the absence of any special circumstances, the Gross Profit Ratio or percentage of the last year may be taken to apply to the current period. If the gross profit percentage, so found, is calculated on the sales for the period, it will represent the estimated profit for the period. Now, the estimated Trading Account can be prepared on the basis of purchases and sales from the beginning of the period upto the date of fire together with the opening stock and the estimated gross profit. The balancing figure in the Trading Account will be taken as the estimated value of stock as at the date of fire.

(b) In arriving at the Gross Profit Percentage on the basis of last year's accounts, care should be taken about the mode of valuation of opening and closing stock. If the stock in the last year has not been valued at cost, the valuation should be adjusted first at cost to determine the appropriate gross profit percentage. The opening stock of the current period should also be taken at cost as the basis of valuation of stock is essentially the cost. For example, if the opening and closing stock of the last year where Rs. 9,000 and Rs.18,000 respectively being valued at 10% below cost, the adjusted opening and closing

stocks would be $9,000 \times \frac{100}{90} = \text{Rs. 10,000}$ and

$18,000 \times \frac{100}{90} = \text{Rs. 20,000}$ respectively.

(c) When gross profit percentage figures for a number of years are available, an

average of these percentages may be taken for finding out estimated gross profit percentage of the current period upto the date of fire. But, if the percentages show a clear upward or downward trend, weighted average or geometric average may be taken.

Note : Sometimes, it may so happen that the percentage of gross profit may be given in the problem. If the given percentage of gross profit is based on cost, it is necessary to ascertain the percentage on sales. If, for example, the percentage of gross profit on cost is given as 25%, percentage on sales has to be ascertained as follows:

Let the cost price be 100. Therefore, profit = 25

∴ Selling price = 100 + 25 = 125

∴ Percentage of G.P. on sales = $\frac{25}{125} \times 100 = 20\%$

- (d) Once the estimated value of stock as at the date of fire is ascertained the next step is to determine the amount of loss of stock by fire. For this, the salvaged stock, if any, has to be deducted from the estimated value of stock as at the date of fire. The remainder will represent the amount of stock lost by fire.
- (e) Now, the average clause, if applicable, has to be applied to determine the amount of claim.

(iii) *Where the books of accounts have also been destroyed by fire:*

- (a) For such a case, it becomes more difficult to obtain the details necessary to prepare the estimated Trading Account. In order to ascertain the approximate amount of sales and purchases all customers and suppliers should be contacted through circulars. From the replies, received from the customers and suppliers and the knowledge of the proportion of cash sales and purchases, the approximate sales and purchases for the period can be estimated. Copies of previous Profit and Loss Account and Balance Sheets are usually available in the hands of auditors or income tax authorities and as such there should be no difficulty in arriving at the value of opening stock and the usual percentage of gross profit on sales. Now, it is possible to prepare the Trading Account and to ascertain the estimated value of stock as at the date of fire.
- (b) The next step is to determine the amount of loss of stock by fire. For this, the salvaged stock, if any, has to be deducted from the estimated value of stock as at the date of fire. The remainder will represent the amount of stock lost by fire.
- (c) Now, the average clause, if applicable, has to be applied to determine the amount of claim.

Illustration 1 : A trader took out a fire policy containing an average clause covering his stock for Rs. 15,000. His practice was to base his selling price at cost plus 33⅓%. He closes his books on 30th June every year.

On 31st March, 2007, a fire occurred at his premises and destroyed his stock. The salvaged stock was Rs. 6,000. During the period of 9 months preceding the fire his purchases amounted to Rs. 61,000, and sales to Rs. 84,000. His stock at 1st July, 2006 was valued at Rs. 20,000.

You are required to prepare a statement showing the amount of claim.

Solution:

Trading Account for the period of 9 months, from 1.7.2006 to 31.3.2007

Dr.			Cr.		
Rs.			Rs.		
To	Opening Stock	20,000	By	Sales	84,000
"	Purchases	61,000	"	Closing Stock	
				(Balancing figure)	18,000
"	Gross Profit @ 25% on Sales*	21,000			
		<u>1,02,000</u>			<u>1,02,000</u>

Statement showing the Amount of Claim for the Loss of Stock

	<i>Rs.</i>
Estimated value of stock as at the date of fire, i.e., on 31.3.2007 as per Trading Account	18,000
Less : Value of salvaged stock	<u>6,000</u>
Estimated value of stock lost by fire	<u>12,000</u>

Applying Average Clause,

$$\begin{aligned} \text{Amount of Claim} &= \text{Loss Suffered} \times \frac{\text{Sum Insured}}{\text{Actual Insurable Value}} \\ &= \text{Rs. } 12,000 \times \frac{\text{Rs. } 15,000}{\text{Rs. } 18,000} = \text{Rs. } 10,000 \end{aligned}$$

* 33 1/3% on cost is the same as 25% on selling price.

Illustration 2: The Trading Account of X Co. for the year ended 31st December, 2006 is given below:

Dr.			Cr.		
		Rs.	Rs.		
To	Opening Stock	34,240	By	Sales less returns	98,000
"	Purchases less returns	78,470	"	Closing Stock	29,410
"	Gross Profit c/d	14,700			
		<u>1,27,410</u>			<u>1,27,410</u>

A fire occurred in the godown of the company on 30th June, 2007 and a considerable part of the stock was destroyed. The salvaged stock was worth Rs. 1,750. The stock was fully insured against fire risks.

Considering the following further particulars prepare a statement showing the amount of claim to be lodged by X Co. with the insurance company for the loss of stock.

Sales for the period ending 30th June, 2007 were Rs. 54,600. The amount paid for purchases was Rs. 44,000 including a cheque of Rs. 360 which remains unrepresented to the bankers upto 30.6.2007. As shown by the books of accounts trade creditors on 31.12.2006 amount to Rs. 12,300 and on 30.6.2007 they were Rs. 11,050. Goods worth Rs. 3,190 were returned to creditors during the period ending 30.6.2007.

Solution:

**Trading Account for the period of 6 months, i.e.,
from 1.1.2007 to 30.6.2007**

Dr.		Rs.		Cr.
To Opening Stock		29,410	By Sales	54,600
" Purchases	45,940		" Closing Stock	
Less: Returns	<u>3,190</u>	42,750	(Balancing figure)	25,750
" Gross Profit				
@ 15% on Sales		8,190		
		<u>80,350</u>		<u>80,350</u>

Statement showing the amount of claim for loss of stock

	Rs.
Estimated value of stock as at the date of fire, i.e., on 30.6.2007 as per Trading Account	25,750
Less : Value of salvaged stock	<u>1,750</u>
	<u>24,000</u>

Working Notes:

- Gross profit percentage for the previous year ended 31.12.2006

$$\frac{\text{Gross Profit}}{\text{Sales}} \times 100 = \frac{\text{Rs. 14,700}}{\text{Rs. 98,000}} \times 100 = 15\%$$
- Purchases during the period ending 30.6.2007 has been ascertained as follows:

Trade Creditors Account

	Rs.		Rs.
To Returns	3,190	By Balance b/d	12,300
" Bank	44,000	" Purchases (Balancing Figure)	45,940
" Balance c/d	11,050		
	<u>58,240</u>		<u>58,240</u>

Illustration 3 : Due to heavy fire in the godown of a company on 1st October, 2007, the entire stock was burnt except some costing Rs. 35,000. The books were, however, saved.

From the information available it was found that:

- The company's average gross profit was 25% on sales.
- The stock on 31st March, 2007 valued at 10% above cost was Rs.1,10,000.
- The purchases and sales from 1st April, 2007, upto the date of fire were Rs. 1,50,000 and Rs. 3,40,000 respectively.
- The wages for the period amounted to Rs. 72,000.
- The company insured the stock for Rs. 60,000.
- The policy had an average clause.

You are required to prepare a statement showing the amount of stock lost by fire and the amount of claim to be lodged with the Insurance Company.

Solution:

Trading Account for the period of 6 Months, from 1.4.2007 to 30.9.2007

To Opening Stock	Rs.	By Sales	Rs.
$\left(1,10,000 \times \frac{100}{110}\right)$	1,00,000	By Closing Stock	3,40,000
To Purchases	1,50,000	(Balancing figure)	67,000
To Wages	72,000		
To Gross Profit @ 25% on Sales	85,000		
	<u>4,07,000</u>		<u>4,07,000</u>

**Statement showing the amount of stock lost by fire and
the amount of claim to be lodged**

	Rs.
Estimated cost price of stock as on 1.10.2007	67,000
Less: Value of salvaged stock	<u>35,000</u>
Amount of stock lost by fire	<u>32,000</u>

Applying Average Clause,

$$\text{Amount of Claim} = \text{Loss Suffered} \times \frac{\text{Sum Insured}}{\text{Actual Insurable Value}}$$

$$= \text{Rs. } 32,000 \times \frac{\text{Rs. } 60,000}{\text{Rs. } 67,000} = \text{Rs. } 28,657$$

Illustration 4 : Mahesh & Company prepares accounts on 31st March each year, but on 30th June 2007 a fire in the godown destroyed the greater parts of his stock. Following information was collected from his books:

	Rs.
Stock as on 1 st April, 2007	59,400
Purchases from 1 st April 2007 to 30 th June 2007	1,50,000
Wages from 1 st April 2007 to 30 th June 2007	66,000
Sales from 1 st April 2007 to 30 th June 2007	2,80,000

The rate of gross profit is $33\frac{1}{3}\%$ on cost. Stock to the value of Rs.6,000 was salvaged.

Insurance policy was taken for Rs.50, 000 and claim was subject to average clause. The following additional information is available:

- (i) Stock in the beginning of the year was calculated at 10% less than cost.
- (ii) A plant was installed by firm's own workers. They were paid Rs. 1,000, that was included in wages.
- (iii) Purchases include the purchase of the plant for Rs.10, 000.

You are required to calculate the claim for the loss of stock.

Solution:

Computation of claim for loss of stock :

	(Rs.)
Stock on the date of fire i.e. 30.6.2007	61,000
Less : Salvaged Stock	6,000
Loss of Stock	<u>55,000</u>

$$\text{Amount of Claim} = \frac{\text{Insured value of stock}}{\text{Total cost of stock on the date of fire}} \times \text{Loss of stock}$$

$$= \frac{\text{Rs. 50,000}}{\text{Rs. 61,000}} \times 55,000 = \text{Rs. 45,082}$$

Working Note:

Memorandum Trading Account is prepared for the period from 01.04.2007 to 30.6.2007 to compute the value of stock on 30.6.2007

**Memorandum Trading Account
For period from 1.4.2007 to 30.6.2007**

Particulars	Rs.	Particulars	Rs.
To Opening Stock Rs. (Rs.59,400 x 100/90)	66,000	By Sales	2,80,000
To Purchases 1,50,000		By Closing Stock	61,000
Less : Cost of plant <u>10,000</u>	1,40,000	(balancing figure)	
To Wages 66,000			
Less : Wages paid for plant <u>1,000</u>	65,000		
To Gross profit (33-1/3% on cost or 25% on sales)	70,000		
	<u>3,41,000</u>		
	=====		<u>3,41,000</u>
			=====

5. POOR SELLING LINE AND TREATMENT OF ABNORMAL ITEMS

Sometimes, the merchandise of an organization may not be sold as regular items or not readily saleable in the market. Such items may partially or completely be written off from the stock. These goods may be sold at a loss or at a rate of profit different from the normal course. These items or products are known as abnormal items or items of poor selling line or slow moving item.

When there is any slow moving item in opening and closing stock valued at below its cost, the valuation should be adjusted to cost price in order to get the normal gross profit percentage.

Now, this percentage should be applied to the sales of regular items upto the date of fire. Opening stock, purchases and sales of regular items should be shown in the Trading Account for the current period to get the estimated value of stock of normal items. The value of the abnormal item of stock should be ascertained separately on the basis of specific information and the same should be added to the value of normal items of stock which will give the value of the total stock as at the date of fire.

Illustration 5 : On 15th September, 2007, the premises of a company were destroyed by fire but sufficient records were saved from which the following particulars were ascertained:

	Rs.
Stock at cost, 1st April, 2006	60,000
Stock at cost, 31st March, 2007	80,000
Purchases, less returns, year ended 31st March, 2007	4, 00,000
Sales, less returns, year ended 31st March, 2007	5, 00,000
Purchases, less returns, 1st April, 2007 to 15th September, 2007	1, 70,000
Sales, less returns, 1st April, 2007 to 15th September, 2007	2, 40,000

In valuing the stock for the balance sheet at 31st March, 2007, Rs. 5,000 had been written off on certain stock which was a poor selling line, having cost of Rs. 8,000. A portion of these goods was sold in June, 2007, at a loss of Rs. 500 on the original cost of Rs. 4,000. The remainder of this stock was now estimated to be worth the original cost. Subject to the above exception, gross profit had remained at a uniform rate throughout.

The stock salvaged was Rs. 7,000.

Show the amount of the claim.

Solution:

Trading Account of the period from 1.4.2007 to 15.9.2007

Dr.							Cr.
	Normal items Rs.	Abnormal items Rs.	Total Rs.		Normal items Rs.	Abnormal items Rs.	Total Rs.
To Opening Stock	77,000	8,000	85,000	By Sales	2,36,500	3,500	2,40,000
To Purchase	1,70,000	—	1,70,000	By Loss on Sales	—	500	500
Less returns				By Closing Stock	69,625	4,000	73,625
To Gross Profit 25% on Rs. 2,36,500	59,125	—	59,125	(Balancing figure)			
	<u>3,06,125</u>	<u>8,000</u>	<u>3,14,125</u>		<u>3,06,125</u>	<u>8,000</u>	<u>3,14,125</u>

Statement showing the amount of claim for loss of stock

	Rs.
Value of stock	73,625
Less : Value of salvaged stock	<u>7,000</u>
Loss of Stock	<u>66,625</u>

Working Note:

(1) **Trading Account for the year ended 31.3.2007**

Dr.				Cr.
	Rs.			Rs.
To Opening Stock	60,000	By Sales less returns		5,00,000
To Purchase less returns	4,00,000	By Closing Stock:		
To Gross Profit c/d	1,25,000	Normal	77,000	
		Abnormal	<u>8,000</u>	<u>85,000</u>
	<u>5,85,000</u>			<u>5,85,000</u>

$$(2) \text{ Percentage of gross profit on sales} = \frac{\text{Rs. } 1,25,000}{\text{Rs. } 5,00,000} \times 100 = 25\%$$

6. ACCOUNTING ENTRIES IN THE BOOKS OF THE INSURED

The following entries are required to be passed in the books of the insured when a fire destroys the stock which is insured under a fire policy:

(1) *When the estimated value of stock is ascertained as on the date of fire:*

Fire Claim Account	Dr.	(with the value of the stock at the date of the fire)
To Stock Lost by Fire Account		

(2) *If there is any salvaged stock:*

Stock Account	Dr.	(with the value of the stock salvaged)
To Fire Claim Account		

(3) *When the claim is admitted by the Insurance company:*

Insurance Co.'s Account	Dr.	(with the amount of claim admitted)
Profit and Loss Account	Dr.	(with the amount of claim not admitted)
To Fire Claim Account		(with the total)

(4) *When the amount of claim admitted by the Insurance Company is realised:*

Bank Account	Dr.	(with the amount realised)
To Insurance Co.'s Account		

(5) *When the Stock Lost by Fire Account is transferred to Trading Account:*

Stock Lost by Fire Account	Dr.	(with the cost of the goods lost)
To Trading Account		

7. CLAIM FOR LOSS OF FIXED ASSETS

For the purpose of indemnity, the value of any fixed assets has to be taken as its value as at the date of fire. If any loss is suffered in respect of such assets due to underinsurance, the same has to be treated as a capital loss and as such, it should be written off against the capital reserve of the company. The amount of claim has to be determined in the same manner as it is done in case of loss of stock. But no Trading Account is required to be prepared in this case.

Illustration 6: A company insured its furniture and fixtures for Rs. 25,000 whereas its value to the company was Rs. 30,000. The insurance policy contained an average clause.

A fire took place in the premises of the company and destroyed the furniture and fixtures, the value of that salvaged being Rs. 3,000.

You are required to prepare a statement showing the amount of claim to be lodged with the Insurance Company.

Solution:

Statement showing the amount of claim for loss of furniture and fixtures

	Rs.
Value of furniture and fixtures as on the date of fire	30,000
Less : Value of furniture and fixtures salvaged	<u>3,000</u>
Value of furniture and fixtures lost by fire	<u>27,000</u>

$$\begin{aligned}\text{Amount of Claim} &= \text{Loss Suffered} \times \frac{\text{Sum Insured}}{\text{Actual Insurable Value}} \\ &= \text{Rs. } 27,000 \times \frac{\text{Rs. } 25,000}{\text{Rs. } 30,000} = \text{Rs. } 22,500\end{aligned}$$

8. CLAIM FOR LOSS OF PROFITS OR CONSEQUENTIAL LOSS

When a fire occurs in a business it destroys not only the property of the business, such as building, machinery, furniture, stock etc. but it also destroys or at least seriously affects the trading results during the period of dislocation due to partial or complete cessation of business activity. An ordinary fire insurance policy covers only the risk of loss of property by fire. Therefore, in order to cover the loss of profit, a separate insurance known as 'loss of profits insurance' or 'consequential loss insurance' has come into vogue. This type of insurance has, for its purpose, the indemnification of the insured for loss arising from suspension, wholly or in part, of the activities of the business consequent on the destruction of business properties by fire. A pre-requisite to any form of loss of profits insurance is that the insured property is also insured against loss of property and goods by fire. It is to be noted that no claim in respect of loss of profits is admitted unless there is an admission of liability for loss of property or stocks by fire, but the amount of claim for loss of profit has no relationship with the amount of claim admitted for loss of property. The loss of profits policy covers the following risks consequent upon fire:

- (i) Loss of net profits due to cessation of business activities.
- (ii) Non-recovery of standing or fixed charges.
- (iii) Increased cost of workings such as renting premises temporarily, temporary repairs to damaged property etc.

Loss of profit or consequential loss policies vary considerably depending on the circumstances of each particular case. But the following conditions are generally contained in such a policy:

- (i) The period of indemnity is fixed in the policy. This period of indemnity or the period of dislocation, whichever is less, is the period for which expected profit that is lost should be considered. For example, if the indemnity period is six months and the dislocation continues for a period of nine months, the loss of profit for the indemnity period of six months would be considered. On the other hand, if the dislocation continues for four months in the same case, the loss of profit for the dislocation period of four months would be considered.
- (ii) The normal method of calculating a claim under such a policy is by way of a percentage which the turnover is expected to earn. This percentage is applied on the loss of turnover caused by fire during the indemnity period or the dislocation period, whichever is less. The resultant figures give the amount of the claim subject to the "Special Circumstances Clause" and "Average Clause" if any.

- (iii) The percentage which the turnover is expected to earn, i.e., the gross profit ratio is calculated on the basis of trading results of the last accounting year. For this purpose, the gross profit is the sum produced by adding the amount of the insured standing charges to the net profits. If there is no net profit, the amount of net loss is to be deducted from the amount of the insured standing charges. The insured standing charges are those charges specified in the policy which the insured desires to recover in the event of damage. Thus, the gross profit ratio is calculated in the following way:

$$\text{Gross Profit Ratio} = \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Turnover}} \times 100$$

In case of a net loss, the gross profit ratio is calculated in the following way:

$$\text{Gross Profit Ratio} = \frac{\text{Insured Standing Charges} - \text{Net Loss}}{\text{Turnover}} \times 100$$

For example, if the net profits and sales for the last accounting year are Rs. 15,000 and Rs. 1,00,000 respectively and standing charges are Rs. 15,000 out of which Rs. 5,000 is uninsured, the gross profit ratio will be as follows:

$$\begin{aligned} \text{Gross Profit Ratio} &= \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Turnover}} \times 100 \\ &= \frac{\text{Rs. 15,000} + \text{Rs. 10,000}}{\text{Rs. 1,00,000}} \times 100 \text{ i.e. } \frac{\text{Rs. 25,000}}{\text{Rs. 1,00,000}} \times 100 = 25\% \end{aligned}$$

The above percentage of gross profit is also called insured gross profit ratio. It is important to note here that the net profit and standing charges bear a direct relationship to the turnover of a business. As such, the turnover as a basis for measuring the loss of profit sustained provides a reliable guide.

- (iv) The loss of turnover in the dislocation period subject to the maximum of the period of indemnity is ascertained by comparing the actual turnover for the period with the turnover for the corresponding period in the preceding year known as the standard turnover. Thus, the loss of turnover is the difference between the actual turnover for the dislocation period or the indemnity period, whichever is less and the standard turnover for the corresponding period in the preceding year. For example, if a fire occurs on 31st January, 2007 and the period of indemnity is for 3 months while the dislocation period is 6 months, a comparison has to be made between the actual turnover for the indemnity period of 3 months, i.e., February, March and April, 2007.
- (v) There is usually a clause for indemnity to cover an increase in the cost of working with the definite object of avoiding or reducing the loss of turnover which would have taken place without such increased cost of working. There are, however, certain limitations which should be taken into consideration in determining the amount of claim. These limitations are:
- (a) Where all the insurable standing charges are not covered by the policy, a proportion of the increased cost is allowed as claim which has to be calculated by applying the following formula:

$$\text{Increased Working Cost} = \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Net Profit} + \text{All Insurable Standing Charges}}$$

- (b) The amount of claim can never exceed the sum produced by applying the gross

profit ratio to the reduction of turnover avoided with increased cost of working, i.e., the maximum saving of liability of the insurer.

- (c) If there is any savings in insured standing charges, the same has to be deducted from the amount of claim for increased cost of working.

Suppose, the gross profit ratio of a business is 20%. Net profit of the business for the last accounting year is Rs. 20,000. Insured and uninsured standing charges are Rs. 30,000 and Rs. 10,000 respectively. Increased cost of working is Rs. 12,000 with a saving of insured standing charges Rs. 500. Reduction in turnover avoided through increased cost of working is Rs. 30,000.

The amount of claim for increased cost of working will be determined as follows:

Amount of claim for increased working cost will be restricted to the minimum of the following two items:

- (i) Proportion of increased cost of working:

$$\begin{aligned} & \text{Increased Working Cost} \times \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Net Profit} + \text{All Insurable Standing Charges}} \\ &= \text{Rs. } 12,000 \times \frac{\text{Rs. } 20,000 + \text{Rs. } 30,000}{\text{Rs. } 20,000 + \text{Rs. } 40,000} \\ &= \text{Rs. } 12,000 \times \frac{\text{Rs. } 50,000}{\text{Rs. } 60,000} = \text{Rs. } 10,000 \end{aligned}$$

- (ii) Maximum saving of liability of the insurer:

Reduction in turnover avoided x Gross Profit Ratio

$$= \text{Rs. } 30,000 \times \frac{20}{100} = \text{Rs. } 6,000$$

Therefore, the amount of claim for increased cost of working will be restricted to Rs. 6,000.

	Rs.
Now, the amount of claim for increased cost of working	6,000
Less : Savings in insured standing charges	<u>500</u>
Amount of net claim	<u>5,500</u>

- (vi) There is usually included in the policy a clause known as "Special Circumstances Clause" which states that such adjustment shall be made as may be necessary to provide for the trend of the business for variations in or special circumstances affecting the business. Such a clause would invariably affect the calculation of the gross profit ratio, the loss of turnover and the increased cost of working. As such, while calculating the gross profit ratio, the loss of turnover and the increased cost of working, care should be taken to adjust such factor.

For example, if the gross profit ratio for the last accounting year is 20% and there is a possibility of an increase of 2% in the current year which is stipulated in the policy through special circumstances clause, the adjusted gross profit ratio will be 22.

Similarly, if sales show a 10% upward trend annually, standard sales for the corresponding period in the preceding year has to be adjusted first by adding 10% to it in order to ascertain in the loss of the turnover.

- (vii) **Average Clause** : This is a limiting clause which is applicable in case of under-insurance. If the sum insured is less than the sum produced by applying the adjusted gross profit ratio to the adjusted turnover for the period of 12 months immediately before the date of fire, the

policy is said to be underinsured. In such a case, the amount of the claim should be proportionately reduced.

- (viii) The Insurance Company will not admit a claim for loss of profits unless there is also, in addition, an admission of liability for loss of stock or property by fire. This is so because it may be quite possible that the business of the insured may suffer due to the fire in the neighbourhood without causing damage to the property of the insured.

9. DETERMINATION OF AMOUNT OF CLAIM FOR LOSS OF PROFITS

As the determination of the amount of claim for loss of profits may involve considerable amount of calculations of complex nature, the following steps should be taken while formulating such a claim:

- (i) Fixing the period of the claim by taking the period of indemnity or the period of dislocation, whichever is less.
- (ii) Ascertaining the loss of turnover in the claim period with due regard to the special circumstances clause, if any.
- (iii) Calculating the gross profit ratio based on the trading results of the last accounting year with due regard to the special circumstances clause, if any.
- (iv) Computing the gross profit lost during the period of claim by applying the gross profit ratio to the loss of turnover during the period of claim.
- (v) Adding thereto increased cost of working, if any, keeping in view of the restrictions stated in clause (v) to arrive at the amount of gross claim.
- (vi) Ascertaining the amount of net claim by applying the "Average Clause".

Illustration 7: From the following details determine the amount of claim under a loss of profit insurance policy:

Indemnity period	—	6 months
Date of fire	—	1.4.2007
Dislocation upto	—	1.8.2007
		Rs.
Sum insured		60,000
Sales for the last accounting year		2,40,000
Net profit for the last accounting year		26,000
Standing charges for the last accounting year (all insured)		34,000
Sales for the year 1.4.2006 to 31.3.2007		3,20,000
Sales for the dislocation period, i.e., 1.4.2007 to 1.8.2007		30,000
Sales for the corresponding period in the preceding year, i.e. 1.4.2006 to 1.8.2006		1,00,000

The policy contains "special circumstances clause" which stipulates for increase of turnover (standard and annual) by 10% as there is an upward trend in the business.

Solution:

Computation of the Amount of Claim

- (1) Period of claim = Dislocation period (being less than Indemnity period) 4 months from 1.4.2007 to 1.8.2007
- (2) Loss of turnover in the dislocation period:
Rs.
Standard turnover for the corresponding period in the preceding year, i.e., 1.4.2006 to 1.8.2006 1,00,000

Add : Agreed increase of 10% for upward trend	<u>10,000</u>
Adjusted standard turnover	1,10,000
Less : Actual turnover in the dislocation period	<u>30,000</u>
Loss of turnover in the dislocation period	<u>80,000</u>

(3) Gross profit ratio based on the trading results of the last accounting year

$$\text{Gross Profit Ratio} = \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Turnover}} \times 100$$

$$= \frac{(26,000 + 34,000)}{2,40,000} \times 100 = \frac{60,000}{2,40,000} \times 100 = 25\%$$

(4) Gross profit lost during the dislocation period:

Loss of gross profit = Loss of turnover x Gross profit ratio

$$= \text{Rs. } 80,000 \times \frac{25}{100} = \text{Rs. } 20,000$$

(5) Application of Average Clause:

Annual turnover preceding the date of fire	<i>Rs.</i> 3,20,000
Add : Agreed increase of 10% for upward trend	<u>32,000</u>
Adjusted annual turnover	<u>3,52,000</u>

$$\text{Insurable amount of the loss of profit: } \frac{25}{100} \times \text{Rs. } 3,52,000 = \text{Rs. } 88,000$$

Applying average clause:

$$\begin{aligned} \text{Amount of Net Claim} &= \text{Loss Suffered} \times \frac{\text{Sum Insured}}{\text{Actual Insurable Value}} \\ &= \text{Rs. } 20,000 \times \frac{\text{Rs. } 60,000}{\text{Rs. } 88,000} \\ &= \text{Rs. } 13,636 \end{aligned}$$

Alternatively the amount of claim may be calculated as follows:

Loss of turnover in the dislocation period = Rs. 80,000

Amount of claim will be restricted to the lower of the two percentages calculated below:

$$(1) \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Sales in previous year}} \times 100$$

$$= \frac{\text{Rs. } 26,000 + \text{Rs. } 34,000}{\text{Rs. } 2,40,000} \times 100 = 25\%$$

$$(2) \frac{\text{Amount of the Policy}}{\text{Sales in the 12 months preceding the date of fire as adjusted for any trends}} \times 100$$

$$= \frac{\text{Rs. } 60,000}{\text{Rs. } 3,52,000} \times 100 = 17 \frac{1}{22} \%$$

$$\therefore \text{Claim} = 17 \frac{1}{22} \% \text{ of Rs. } 80,000 = \text{Rs. } 13,636$$

Illustration 8 : The premises of a company were partly destroyed by fire which took place on 1st June, 2007 and as a result of which the business was disorganised from 1st June, 2007 to 31st October, 2007. Accounts are closed on 31st March every year. The company is insured under a loss of profits policy for Rs. 75,000. The period of indemnity specified in the policy is 6

months. From the following information you are required to compute the amount of claim under the loss of profit policy:

	Rs.
Turnover for the year ended 31.3.2007	4,00,000
Net profits for the year ended 31.3.2007	24,000
Insured standing charges	48,000
Uninsured standing charges	8,000
Turnover during the period of dislocation, i.e., from 1.6.2007 to 31.10.2007	80,000
Standard turnover for the corresponding period in the preceding year, i.e., from 1.6.2006 to 31.10.2006	2,00,000
Annual turnover for the year immediately preceding the fire, i.e., from 1.6.2006 to 31.5.2007	4,40,000
Increased cost of working	15,000
Savings in insured standing charges	3,000
Reduction in turnover avoided through increase in working cost	40,000
Owing to reasons acceptable to the insurer the "special circumstances clause" stipulates for:	
(a) Increase of turnover (standard and annual) by 10%; and	
(b) Increase of rate of gross profit by 2%.	

Solution:

Computation of the Amount of Claim

(1) Period of claim = Dislocation period (being less than indemnity period) 5 months from 1.6.2007 to 31.10.2007.

(2) Loss of turnover in the dislocation period:

Standard turnover for the corresponding period in the preceding year, i.e., from 1.6.2006 to 31.10.2006	2,00,000
Add : Agreed increase for upward trend @ 10%	<u>20,000</u>
Adjusted standard turnover	2,20,000
Less : Actual turnover in the dislocation period	<u>80,000</u>
Loss of turnover in the dislocation period	<u>1,40,000</u>

(3) Gross profit ratio based on the trading results of the last accounting year, i.e., 2006-2007:

$$\begin{aligned}
 \text{Gross Profit Ratio} &= \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Turnover}} \times 100 \\
 &= \frac{\text{Rs. } (24,000 + 48,000)}{\text{Rs. } 4,00,000} \times 100 \\
 &= 18\%
 \end{aligned}$$

Adjusted gross profit ratio = 18% + Agreed increase by 2% = 20%.

(4) Gross profit lost during the dislocation period:

$$\begin{aligned}
 \text{Loss of gross profit} &= \text{Loss of turnover} \times \text{Adjusted gross profit ratio} \\
 &= \text{Rs. } 1,40,000 \times \frac{20}{100} = \text{Rs. } 28,000
 \end{aligned}$$

(5) Increased working cost:

Increased working cost Rs. 15,000

Amount of claim is restricted to the lower of the following two:

(a) Proportionate working cost:

$$\begin{aligned} \text{Increased Working Cost} &\times \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Net Profit} + \text{All Insurable Standing Charges}} \\ &= \text{Rs. } 15,000 \times \frac{\text{Rs. } (24,000 + 48,000)}{\text{Rs. } (24,000 + 56,000)} \\ &= \text{Rs. } 15,000 \times \frac{\text{Rs. } 72,000}{\text{Rs. } 80,000} = \text{Rs. } 13,500 \end{aligned}$$

(b) Maximum saving of liability of the insurer:

Gross profit on the reduction in turnover avoided through
increased cost of working

$$= \text{Rs. } 40,000 \times \frac{20}{100} = \text{Rs. } 8,000$$

	Rs.	of
Therefore the amount of claim for increased cost working will be restricted to	8,000	
Less: Savings in insured standing charges	<u>3,000</u>	
Net amount of claim for increased cost of working	<u>5,000</u>	

Statement of Claim

Rs.	
Claim for loss of profit as per (4) above	28,000
Claim for loss on account of increased working cost as per (5) above	<u>5,000</u>
Amount of gross claim	<u>33,000</u>

(6) Application of average clause:

	Rs.
Annual turnover preceding the date of fire	4,40,000
Add: Agreed increase of 10% for upward trend	<u>44,000</u>
Adjusted annual turnover	<u>4,84,000</u>

$$\text{Insurable amount of loss of profit} = \text{Rs. } 4,84,000 \times \frac{20}{100} = \text{Rs. } 96,800$$

Applying average clause,

$$\begin{aligned} \text{Amount of Net Claim} &= \text{Loss Suffered} \times \frac{\text{Sum Insured}}{\text{Actual Insurable Value}} \\ &= \text{Rs. } 33,000 \times \frac{\text{Rs. } 75,000}{\text{Rs. } 96,800} \\ &= \text{Rs. } 26,568 \end{aligned}$$

Illustration 9 : C Ltd. has a "loss of profit" insurance policy of Rs. 21,00,000. The period of indemnity is three months. A fire occurred on 30th June, 2007. The following information is available:

	<i>Rs.</i>
Sales:	
For the year ended 31st March, 2007	70,00,000
For the period from 1st July, 2006 to 30th June 2007	80,00,000
For the period from 1st July, 2006 to 30th September, 2006	18,00,000
For the period from 1st July, 2007 to 30th September, 2007	1,20,000
Standing charges for 2006-2007	16,00,000
Profit for 2006-2007	5,00,000
Saving in standing charges because of fire	50,000
Additional expenses to reduce loss of turnover	1,00,000

Assuming no adjustment has to be made for the upward trend in turnover, compute the claim to be made on the insurance company.

Solution:

Computation of the Amount of Claim

(1) Period of the claim: Indemnity period, i.e., 3 months from 1.7.2007 to 30.9.2007.

(2) Loss of turnover in the indemnity period:

Turnover for the corresponding period in the preceding year, i.e., 1.7.2006 to 30.9.2006	<u><i>Rs.</i></u>
	18,00,000
Less : Actual turnover in the indemnity period, i.e., 1.7.2007 to 30.9.2007	<u>1,20,000</u>
Loss of turnover in the indemnity period	<u>16,80,000</u>

(3) Gross profit ratio based on the trading results of the last accounting year, i.e., 2006-2007

$$\begin{aligned} \text{Gross Profit Ratio} &= \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Turnover}} \times 100 \\ &= \frac{\text{Rs. } (5,00,000 + 16,00,000)}{\text{Rs. } 70,00,000} \times 100 \\ &= \frac{\text{Rs. } 21,00,000}{\text{Rs. } 70,00,000} \times 100 = 30\% \end{aligned}$$

(4) Gross profit lost during the indemnity period:

$$\begin{aligned} \text{Loss of gross profit} &= \text{Loss of turnover} \times \text{Gross profit ratio} \\ &= \text{Rs. } 16,80,000 \times \frac{30}{100} \\ &= \text{Rs. } 5,04,000 \end{aligned}$$

(5) Increased working cost:	<i>Rs.</i>
Additional expenses to reduce loss of turnover	1,00,000
Assume that all the standing charges are insured, amount of claim will be restricted to the maximum saving of liability to the insurer, i.e., Amount of reduction in turnover avoided through additional expenses x Gross profit ratio	
$= \text{Rs. } 1,20,000 \times \frac{30}{100} = \text{Rs. } 36,000$	

Statement of Claim

	<i>Rs.</i>
Claim for loss of profit as per (4) above	5,04,000
Claim for loss account of additional expenses as per (5) above	<u>36,000</u>
	5,40,000

Less: Savings in insured standing charges	<u>50,000</u>
Amount of gross claim	<u>4,90,000</u>

(6) Application of Average Clause:

Annual turnover preceding the date of fire	Rs. 80,00,000
∴ Insurable amount of loss of profit = $\frac{30}{100} \times \text{Rs. } 80,00,000$	= 24,00,000

Applying average clause,

$$\begin{aligned} \text{Amount of Net Claim} &= \text{Loss Suffered} \times \frac{\text{Sum Insured}}{\text{Actual Insurable Value}} \\ &= \text{Rs. } 4,90,000 \times \frac{\text{Rs. } 21,00,000}{\text{Rs. } 24,00,000} \\ &= \text{Rs. } 4,28,750 \end{aligned}$$

- Note :** (1) All the standing charges have been assumed as insured in the absence of any information.
- (2) In the absence of any information, it is assumed that all the sales in the indemnity period have been effected as a result of additional expenses.

10. DETERMINATION OF THE AMOUNT TO BE INSURED UNDER A LOSS OF PROFITS POLICY

While taking out a loss of profits policy, care should be taken to see that the amount to be insured is sufficient to cover the risk of loss of profits. As the fixed expenses or standing charges continue to be the same in the dislocation period, the same is bound to increase loss of profits and hence the policy amount should include the standing charges. Therefore, the estimated gross profit for the period for which the policy is to be taken out should be considered. One has to depend on the last year's trading results adjusted to future trends.

Illustration 10: A company has decided to arrange for a loss of profits insurance and you are asked to compute the sum to be insured on a full insurance basis from the following figures for the last financial year. It is anticipated that for the current financial year, turnover will increase by 10% and that all standing charges will remain unchanged.

	Rs.	Rs.
Variable expenses		2,10,000
Wages and salaries to skilled employees and salaries to administrative staff	30,000	
Depreciation on fixed assets	10,000	
Insurance premium	1,000	
Auditors' fees	800	
Traveling expenses	4,000	
Postage and telegrams	400	
Rent, rates and taxes	<u>3,000</u>	49,200
Non-operating income		5,000
Net profit		45,800

Solution:

Turnover for the last financial year is missing in the problem which can be ascertained by preparing a summarised Profit and Loss Account as follows:

Summarised Profit and Loss Account		
	Rs.	Rs.
To Variable Expenses	2, 10,000	By Sales

” Fixed Expenses	49,200	(Balancing figure)	3, 00,000
” Net Profit	45,800	” Non-Operating Income	<u>5,000</u>
	<u>3, 05,000</u>		<u>3, 05,000</u>
			Rs.
Turnover for the year			3, 00,000
Less: Variable expenses			<u>2, 10,000</u>
Gross profit for the year			<u>90,000</u>

Alternatively,

Gross profit = Net profit – Non-operating income + Standing charges.
= Rs. (45,800 – 5,000 + 49,200) = Rs. 90,000

Gross profit ratio = $\frac{\text{Gross Profit}}{\text{Turnover}} \times 100$
= $\frac{\text{Rs. 90,000}}{\text{Rs. 3,00,000}} \times 100 = 30\%$

Amount for Loss of Profits Policy

Turnover on the basis of last financial year	3,00,000
Add: Estimated increase in turnover @ 10%	<u>30,000</u>
Estimated turnover for the current year	<u>3,30,000</u>
$\therefore \text{Amount to be insured} = \frac{30}{100} \times \text{Rs. 3,30,000} = \text{Rs. 99,000}$	

11. CLAIMS UNDER OTHER TYPES OF INSURANCE

While determining the amount of claim under other types of insurance covering different types of risks, the circumstances of each particular case should be separately considered. Generally, these claims involve recovery of damages or compensation in respect of personal injuries or disability or disturbance of a business as a result of the compulsory acquisition of premises by a local authority or the government.

In the case of a claim for damages in respect of personal injuries sustained, the following factors should be considered:

- The income of the claimant before injuries are sustained.
- The extent of the injuries sustained.
- Whether disability is permanent or temporary.
- Whether disability is total or partial.
- The period of disability.
- Whether injuries are sustained due to the negligence of the claimant.
- In case of business, whether the claimant can easily realise the full amount of the capital in his business or whether a loss will be incurred.

Similarly, where the claim for compensation is on account of disturbance in business as a result of the compulsory acquisition of premises by a local authority or the Government, the following factors should be considered:

- The loss on trading which may be sustained.
- Removal expenses.
- Probable damage or loss in respect of fixtures and fittings.
- Increased rent for alternative premises.
- Loss in connection with the sale, removal or damage to other assets.
- Increased cost of new lease and loss in respect of unexpired portion of the old lease.

- (g) Loss of goodwill.
- (h) Possible inability to complete contracts within the stipulated period.
- (i) Loss of rent in case of sub-letting.
- (j) Loss of stationery etc., bearing the address of the old premises.

SELF-TEST QUESTIONS

1. (a) A manufacturing company earned gross profit normally @ 30% of sales but towards the end of accounting year 2006-07 it had installed equipment which would reduce costs by 3% of sales. On 15th July, 2007 there was a fire which destroyed the stocks. Estimate the value of the stocks on that date from the following figures:

	Rs.
Stocks on 1st April, 2007	1,20,000
Materials consumed	3, 10,000
Wages and other manufacturing expenses	1, 75,000
Sales	5, 50,000

- (b) In the above case, if the stock salvaged was Rs. 86,500 and the policy was for Rs. 2, 00,000 with an average clause, what would be the claim?

[Ans. : (a) Rs. 2, 36,500; (b) Rs. 1, 26,850]

2. While preparing the accounts for 2006-07, it was found that an item purchased for Rs. 50,000 did not move at the normal selling price; 1/4th of this item was sold for Rs. 10,000 and the remainder was valued at Rs. 25,000. The 2006-07 trading account revealed the following:

	Rs.		Rs.
Stock (1.4.2006)	85,000	Sales	8, 00,000
Purchases	6, 50,000	Closing stock	95,000
Gross profit	1, 60,000		
	<u>8, 95,000</u>		<u>8, 95,000</u>

In June 2007 there was a fire. What will be the gross profit ratio for that purpose of calculating the claim?
(Ans.: 22.15%)

3. Fire occurred on the premises of the Uma Traders on 4th May, 2007. All the stocks with the exception of Rs. 13,000 were destroyed by fire. From the following figures, ascertain the loss suffered by Uma Traders:

	Rs.
Stock on 1 st January 2006	36,000
Stock on 31 st December 2006	66,000
Purchases during 2006	4, 80,000
Sales during 2006	6, 00,000
Purchases during 2007 upto the date of fire	2, 30,000
Sales during 2007 upto the date of fire	3, 00,000

On 20th December 2006 also a fire broke out and destroyed stocks at genuine cost of Rs. 10,000. There was a practice in the firm to value stock at cost less 10 per cent. But all of a sudden they changed this practice and valued stock on 31st December 2006 at cost plus 10%. The amount of policy was Rs. 40,000 and claim was subject to an average clause.

(Ans.: Net claim: Rs. 32,000)

4. On a sale of Rs. 50, 00,000, a company earned a net profit of Rs. 2,00,000 after charging fixed expenses totaling Rs. 9,00,000. In the next year, there was a fire due to which there was no production or sale for a period of 3 months whereas in the corresponding period of the previous year there was a sale of Rs. 15, 00,000. If there was a consequential loss policy, what is the amount of the claim that could be lodged under this policy?

(Ans. : Rs. 3, 30,000)

5. Out of a total fixed expenses of Rs. 20, 00,000, a company got them insured for Rs. 15, 00,000. The net profit for one year was determined at Rs. 5,00,000. The gross profit ratio was agreed at 25%. There was a fire and to reduce the impact of the fire, the company incurred additional expenses of Rs. 80,000 as a result of which the turnover increased by Rs. 3,00,000. What is the amount that will be allowed by the insurer as additional expenses.

(Ans. : Rs. 64,000)

6. A company took out a consequential loss policy; there was a fire due to which working was upset for a period of 4 months and the loss of profits was worked out to be Rs. 1,75,000. The insurer did not admit any claim for loss of machinery as a result of the fire but agrees that the figure given above is correct. The consequential loss policy was for Rs. 1,50,000. What will be the claim for loss of profit?

(Ans.: Nil)

7. A fire occurred on 1st July, 2007, in the premises of Cherry Ltd. and business was disorganised upto 30th November, 2007. From the books of account, the following information was extracted:

	Rs.
Actual turnover from 1 st July, 2007 to 30 th November, 2007	60,000
Turnover from 1 st July, 2006 to 30 th November, 2006	2,00,000
Net profit for the last accounting year	90,000
Insured standing charges for the last accounting year	60,000
Turnover for the last accounting year	5,00,000
Turnover for the year ending 30 th June, 2007	5,50,000
Total standing charges for the year	72,000

The company incurred additional expenses amounting to Rs. 9,000 which reduced the loss in turnover. There was also a saving of Rs. 2,486 during the indemnity period.

The company holds a 'loss of profit' policy for Rs. 1, 65,000 having an indemnity period of 6 months. There had been a considerable increase in trade and it had been agreed that an adjustment of 20% be made in respect of upward trend in turnover.

Compute claim under loss of profit insurance policy.

(Ans : Amount of Claim: Rs. 49,873)

Suggested Readings :

- (1) *M.C. Shukla, T.S. Grewal & S.C. Gupta* – Advanced Accounts (Vol. I)
 - (2) *S.N. Maheshwari* – Advanced Accounting - Vol. I
 - (3) *R.L. Gupta & V.K. Gupta* – Financial Accounting
 - (4) *J.R. Monga* – Advanced Financial Accounting
-

FINANCIAL ACCOUNTING

TEST PAPER 1/2009

Time allowed : 3 hours

Max. marks : 100

NOTE : Answer SIX Questions including Question No. 1 which is **COMPULSORY**. All working notes should be shown distinctly.

1. (a) Explain any two of the following:

- (i) Accrual system of accounting
- (ii) Subsidiary books
- (iii) Accommodation bill
- (iv) Revaluation account.

(5 marks each)

(b) State with reasons in brief, whether the following statements are true or false. Attempt any five.

- (i) The debit balance in cash book shows net income.
- (ii) Overhaul expenses of second hand machinery purchased are revenue expenses.
- (iii) The convention of conservatism takes into account all prospective profits but leaves all prospective losses.
- (iv) Salary paid in advance is not an expense because it neither reduces assets nor increases liabilities.
- (v) The income and expenditure account does not make any difference between capital and revenue receipts and payments.
- (vi) A consignee is paid overriding commission for bearing the risk of bad debts on account of credit sales made by him.
- (vii) In case of insolvency of a partner, his deficiency is borne by the solvent partners in their profit sharing ratio.

(2 marks each)

2. (a) Re-write the following sentences after filling up the blank space with appropriate words(s) so as to convey the correct meaning :

- (i) An expense on major repairs of machinery purchased second hand has been debited to repairs account; it involves an error of _____.
- (ii) When the bank column of a cashbook shows a credit balance, it means _____.
- (iii) If adjustment related to bad debts is given outside the trial balance, then they are adjusted by debiting _____ account and crediting _____ account.
- (iv) Each transaction has two aspects; this fact is called _____ concept.
- (v) Noting charges paid on dishonour of a bill of exchange are ultimately borne by the _____ of the bill.
- (vi) Amount of goodwill received in cash from a new partner is transferred to old partners' capital account in _____ ratio.
- (vii) The assumption of underlying the fixed instalment method of depreciation is that of _____ of the asset over different years.
- (viii) If the rate of gross profit is 20% on cost of goods sold and the sales is Rs. 2,00,000, the amount of gross profit will be _____.

(1 mark each)

(b) Distinguish between any two of the following:

- (i) Trial balance and balance sheet

- (ii) Sinking fund and annuity method of depreciation
- (iii) Income and expenditure account and receipts and payments account
- (iv) Sale and consignment.

(4 marks each)

3. (a) Choose the most appropriate answer from the given options in respect of the following:
- (i) The document ordering the payment of money, drawn by one person on another is known as :
 - (a) Bill of payment
 - (b) Bill of exchange
 - (c) Promissory note
 - (d) Accommodation bill
 - (ii) What is the name given for ascertainment of profit of an organization by statement of affairs method ?
 - (a) Conversion method
 - (b) Net worth method
 - (c) Revaluation method
 - (d) Balance sheet method
 - (iii) The interest lost on the acquisition of an asset is taken into account in calculating depreciation under :
 - (a) Diminishing balance method
 - (b) Depletion method
 - (c) Annuity fund method
 - (d) Insurance policy method
 - (iv) Cash purchases are made of goods of the invoice price of Rs.40,000/- at a trade discount of 5% and cash discount of 2%; the cash payable is :
 - (a) 40,000
 - (b) 38,000
 - (c) 38,800
 - (d) 37,240
 - (v) Accommodation bill is got discounted, the discount is borne:
 - (a) Wholly by the drawer
 - (b) Wholly by the acceptor
 - (c) By the drawer and the acceptor equally.
 - (d) By the drawer and the acceptor in the ratio of funds used by two parties
 - (vi) Value of closing stock to be taken while preparing final account is:
 - (a) Cost price
 - (b) Market price
 - (c) Sale price
 - (d) Cost or market prices whichever is less.
 - (vii) The surplus or deficit shown by income and expenditure account is transferred to:
 - (a) Capital account
 - (b) Receipts and payments account
 - (c) Capital fund account
 - (d) Assets account

(viii) When a partnership is dissolved the following account is opened in the ledger :

- (a) Memorandum revaluation account
- (b) Revaluation account
- (c) Realisation account
- (d) Income and expenditure account

(1 mark each)

(b) Explain any two of the following statements:

- (i) Agreement of trial balance is a conclusive proof of accuracy of accounts
- (ii) Balance sheet is not an account; it is only the list of balances.
- (iii) Accounting is an information system.
- (iv) Single entry system of book-keeping is an unscientific, incomplete and defective system.

(5 marks each)

4. (a) An accountant prepared the trial balance on 31st March, 2009. He put the difference in a newly opened suspense account. Thereafter the following errors were detected :

- (i) Purchase for Rs.680 was written in sales day book, but posted to the correct side of the party's account.
- (ii) Salary account total Rs.15,000 was carried over to the next page as Rs.1,000 on the wrong side.
- (iii) Interest on overdraft Rs.500 was not posted to the interest account from the cash book.
- (iv) Old dues received from a party Rs.1,000 which was written off as bad debts, was credited to the party's account.
- (v) Goods purchased from Xavier for Rs.580 has been posted to the debit of his account as Rs. 850.
- (vi) Furniture sold for Rs. 2,000 was entered in the sales day book.
- (vii) Furniture purchased for Rs.1,500 was entered in the purchase day book.

Pass necessary rectification entries and show the suspense account.

(8 marks)

(b) Anand sold goods to the value of Rs.8,000 to Shankar, taking a bill of three months therefore. Anand discounted the bill at 12% p.a. with his bank. On maturity, the bill was returned by the bank dishonoured with Rs.100 as noting charges. Shankar paid Rs.2,000 plus noting charges and accepted another bill at three months for Rs.6,000 plus 12% interest thereof. But before maturity, he had become bankrupt and ultimately paid to his creditors 60 paise in the rupee. Pass Journal entries in the books of Anand and prepare Shankar's Account in Anand's ledger.

(8 marks)

5. (a) The cash book of Krishna shows a debit balance of Rs.44,500 on 30th June, 2009. On scrutiny it is found that:

- (i) Cheques amounting to Rs.60,000 issued to creditors have not been presented for payment till that date.
- (ii) Cheques paid into bank amounting to Rs.1,05,000 out of which cheques amounting to Rs.55,000 only collected by the bank upto 30th June, 2009.
- (iii) A dividend of Rs.4,000 and rent amounting to Rs.6,000 received by the bank and entered in the Pass Book but not recorded in the cash book.

- (iv) Insurance premium (upto 31st December 2009) paid by the bank Rs.5,700 not entered in the cash book.
- (v) The payment side of the cash book had been undercast by Rs.500.
- (vi) Bank charges Rs.250 shown in the pass book, had not been entered in the cash book.
- (vii) A bill payable for Rs.5,000 has been paid by the bank but is not entered in the cash book and bill receivable for Rs.6,000 has been discounted with the bank at a cost of Rs.200 which has also not been recorded in cash book.

You are required to:

- (i) Make necessary adjustment entries in the cash book; and
- (ii) Prepare a statement reconciling the cash book with the bank pass book.

(8 marks)

- (b) Ajay does not maintain regular books but keeps only memoranda of his transactions. He furnishes the following information from the memoranda for the year ended 31st March 2009.

- (i) Total collections from Debtors (in cash) Rs.3,00,000.
- (ii) Cash sales Rs.1,92,000.
- (iii) The abstract of bank account for the year ended 31st March, 2009.

<i>Particulars</i>	<i>Rs.</i>	<i>Particulars</i>	<i>Rs.</i>
Cash (Deposits)	4,79,100	Balance b/d (on 1.4.2008)	48,000
		Interest and bank charges	900
		Drawings	24,000
		Salaries	1,02,000
		General Expenses	95,100
		Creditors	1,80,000
		Balance c/d	<u>29,100</u>
	<u>4,79,100</u>		<u>4,79,100</u>

- (iv) Other balances on 1st April, 2008 were as follows : Stock—Rs.1,08,000; Debtors—Rs.2,64,000; Furniture Rs.12,000; Buildings Rs.1,80,000; Creditors—Rs.96,000; Cash in hand—Rs.1,000.

- (v) He purchased a second hand motor cycle for Rs.12,000 on 1st January 2009.

- (vi) Besides cash balances, other balances on 31.3.2009 were as follows : Stock—Rs.1,24,000; Debtors—Rs.3,60,000; Creditors—Rs.66,000.

Prepare profit and loss account for the year ended 31st March, 2009 and a balance sheet as on that date after charging depreciation @ 10% p.a. on building, furniture and motor cycle.

(8 marks)

- 6. (a) On 1st April, 2008, a company took an insurance policy for Rs.4,50,000 in respect of goods stored in its godowns. On 23rd August, 2008 there was a loss of goods due to fire. Goods salvaged were valued at Rs.14,500. Find out the amount of the claim for loss of goods after taking into account the following information :

- (i) The company has a policy of selling goods at a price to give a gross profit margin of 25% of the cost.
- (ii) The company values its stock at cost price or market price whichever is lower. On

31st March, 2008, the closing stock was valued at Rs. 4,28,000 which included damaged goods costing Rs.10,000 valued at Rs. 8,000.

- (iii) Purchases from 1st April, 2008 till the date of fire amounted to Rs.11,00,000. during the same period sales amounting to Rs.12,54,800 were made which included the sale of 60% of the damaged goods at book value.

- (iv) The policy contains 'average clause'.

(8 marks)

- (b) Major Ltd., charges depreciation on its plant and machinery @ 10% per annum on the diminishing balance method. On 31st March, 2009 the company decides to adopt straight line method of charging depreciation with retrospective effect from 1st April, 2005, the rate of depreciation being 15%. On 1st July, 2008 the plant and machinery account stood in the books at Rs. 2,91,600. On 1st July, 2008, a sum of Rs. 65,000 was realised by selling a machine cost of which on 1st April, 2009 was Rs.90,000. On 1st January, 2009 a new machine was acquired at a cost of Rs.1,50,000.

Show the plant and machinery account in the books of the company for the year 31st March, 2009.

(8 marks)

7. From the following Receipts and Payments Account of Royal Recreation Club for the year ended 31.3.2009 and additional information given, prepare an Income and Expenditure Account for the year ended 31.3.2009 and Balance Sheet as on 31.3.2009:

<i>Receipts</i>	<i>Rs.</i>	<i>Payments</i>	<i>Rs.</i>
Opening Balance :		Secretary's salary	24,000
Cash in Hand and at Bank	6,360	Salaries to staff	50,000
Subscription	36,000	Charities	2,000
Sale of Old newspapers	5,000	Printing and stationary	1,200
Legacies	8,000	Postage expenses	240
Interest on investments	4,000	Rates and taxes	3,000
Endowment fund receipts	40,000	Upkeep of the land	4,000
Proceeds of sport and concerts	8,040	Purchase of sports materials	20,000
Advertisement in the year book	10,000	Telephone expenses	6,960
		Closing balance :	
		Cash in hand and at bank	6,000
	<u>1,17,400</u>		<u>1,17,400</u>

Assets and liabilities as on 31.3.2008 and 31.3.2009 were as follows :

	31.3.2008	31.3.2009
	(Rs.)	(Rs.)
Subscription in arrears	4,000	2,000
Subscription received in advance	1,000	800
Furniture	4,000	3,000
Building	2,00,000	2,00,000

Legacies received shall be capitalized. Investments were made in securities, the rate of interest being 12% p.a. the date of investment was 1.6.2007 and the amount of investments was

Rs.40,000. Due date of interest is 31st March of every year. Stock of sports materials on 31.3.2009 were useless and valued at nil price.

(16 marks)

8. Bansal and Chandar are partners in a firm sharing profits and losses equally. Their balance sheet as on 31st March, 2009 was as follows :

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Sundry creditors	1,26,000	Cash at bank	14,000
General reserve	70,000	Debtors	1,40,000
Capital Accounts:		Stock	1,68,000
Bansal 2,10,000		Furniture	28,000
Chander <u>1,68,000</u>	<u>3,78,000</u>	Buildings	<u>2,24,000</u>
	<u>5,74,000</u>		<u>5,74,000</u>

Sagar was admitted as a partner and was given one-fourth share of profits on the following terms :

- He would bring Rs.2,10,000 in cash as his capital.
- His share of goodwill was valued at Rs.70,000 but he was unable to bring it in cash.
- Stock and furniture be depreciated by 10%.
- A provision of 5% on debtors be created for doubtful debts.
- An amount of Rs.14,000 included in creditors not to be treated as a liability.
- A provision of Rs. 7,000 be created against bills discounted.
- The buildings be treated as worth Rs. 2,80,000.

It was agreed that except cash, the other assets and liabilities were to be shown at the same old figure in the balance sheet.

Give journal entries to record the transactions and prepare Memorandum Revaluation Account and Capital Accounts of the partners. Also the balance sheet after

admission of Sagar.

(16 marks)

TEST PAPER 2/2009

Time allowed : 3 hours

Maximum Marks : 100

NOTE : Answer SIX Questions including Question No.1 which is compulsory. All working notes should be shown distinctly.

- (a) Explain any two of the following:
 - Realisation concept
 - Marshalling of assets and liabilities
 - Del credere commission
 - Deferred revenue expenditure.

(5 marks each)

(b) State with reasons in brief, whether the following statements are *true or false*. Attempt *any five*.

- (i) Sales book was under cast by Rs.5,000. The rectification entry will decrease gross profit by Rs.5,000.
- (ii) Income tax paid on behalf of the proprietor is debited to profit and loss account.
- (iii) The objective of taking a joint life policy by the partnership firm is to secure the lives of the existing partners of the firm.
- (iv) A provision for doubtful debts is created on debtors who are definitely bad.
- (v) If the date of payment of a bill after taking into account the days of grace falls on a holiday, the payment of the bill is to be made on the following working day.
- (vi) Every consignee is entitled to get a share in the profits of consignment.
- (vii) In the absence of any contract to the contrary, partners are required to share profits and losses equally.

(2 marks each)

2. (a) Re-write the following sentences after filling up the blank space with appropriate words(s) so as to convey the correct meaning:

- (i) Under consequential loss insurance in order to find out the loss of profit, the gross profit ratio is applied on the _____ caused by fire during the indemnity period or the dislocation period.
- (ii) When the pass book shows a credit balance, it means _____.
- (iii) When goods are returned to the supplier a _____ is sent to him.
- (iv) In case of accommodation bills, if one party becomes insolvent then that party credits the short remittance to _____.
- (v) _____ account is prepared to ascertain the cost of goods manufactured.
- (vi) _____ method of depreciation is suitable for calculating depreciation on loose tools.
- (vii) Unrecorded liability paid at the time of dissolution of a partnership is debited to _____ account.
- (viii) Abnormal loss on consignment is credited to _____ account.

(1 mark each)

(b) Distinguish between any two of the following:

- (i) Journal and ledger
- (ii) Bill of exchange and promissory note
- (iii) Statement of affairs and balance sheet
- (iv) Double entry system and single entry system.

(4 marks each)

3. (a) Choose the most appropriate answer from the given options in respect of the following:

- (i) A property worth Rs. 40,000 is insured for Rs.30,000. It is completely destroyed by fire. The policy contains an average clause. What is the loss to be born by the insurance company ?

- (a) Rs. 30,000
- (b) Rs. 40,000

- (c) Rs. 10,000
 - (d) Rs. 50,000
- (ii) Which of the following books is used to record purchase of furniture on credit ?
- (a) Cash book
 - (b) Purchases book
 - (c) Journal proper
 - (d) Sales book
- (iii) While preparing the final accounts of an organization, the closing stock is shown :
- (a) On the asset side of the balance sheet
 - (b) On the credit side of the trading account
 - (c) On the credit side of the profit and loss account
 - (d) On the credit side of the trading account and asset side of the balance sheet.
- (iv) Heavy advertisement expenditure spent on launching a new product is treated as:
- (a) Capital expenditure
 - (b) Deferred revenue expenditure
 - (c) Revenue expenditure
 - (d) Prepaid expenditure.
- (v) Depreciation is provided on the following :
- (a) Intangible assets
 - (b) Investments
 - (c) Current Assets
 - (d) Fixed Assets.
- (vi) A and B are partners in a firm. During the year 2007, A withdrew Rs.1,000 p.m. and B withdrew Rs.500 p.m. on the first day of each month for personal use. Interest on drawing is charged @ 10% p.a. What is the interest on drawings ?
- (a) Rs.1,800
 - (b) Rs.975
 - (c) Rs.900
 - (d) Rs.650.
- (vii) Capital at the beginning and at the end of an accounting year can be ascertained by preparing :
- (a) Income and expenditure account
 - (b) Profit and loss account
 - (c) Statement of affairs
 - (d) Balance sheet.
- (viii) Provision for bad debts and for discount on debtors are made @ 5% and 2% respectively for trade debtors for Rs.1,00,000. The provision for discount on debtors will be :

(a) Rs. 5,000

(b) Rs. 2,500

(c) Rs. 1,900

(d) Rs. 2,050.

(1 mark each)

(b) Explain any two of the following statements:

(i) All transactions have debit and credit aspects.

(ii) Depreciation is a process of allocation and not of valuation.

(iii) Salary paid in advance is not an expense because it neither reduces assets nor increases liabilities.

(iv) Receipts and payments is a summary of cash book. (5 marks each)

4. (a) Gopal draws on Manhar a bill for Rs.45,000 on 1st June, 2009 for three months. Manhar accepts the bill and sends it to Gopal who gets it discounted for Rs.44,100. Gopal immediately remits Rs.14,700 to Manhar. On the due date, Gopal being unable to remit the amount due, accepts a bill for Rs.63,000 for three months which is discounted by Manhar for Rs.61,650. Manhar sends Rs.11,100 to Gopal. On the due date Gopal becomes insolvent, his estate paying sixty paise in the rupee.

You are required to give journal entries in the books of Gopal and Manhar.

(8 marks)

- (b) Anil and Bajaj were partners in a joint venture sharing profits and losses in the proportion of four-fifths and one-fifth respectively. Anil supplies goods to the value of Rs.2,00,000 and incurs expenses amounting to Rs.21,600. Bajaj supplies goods to the value of Rs.56,000 and his expenses amount to Rs.3,200. Bajaj sells goods on behalf of the joint venture and realizes Rs.3,68,000. Bajaj is entitled to a commission of 5% on sales. Bajaj settles his account by bank draft.

Give journal entries and prepare joint venture account and Bajaj's account.

(8 marks)

5. (a) Pal and Singh were in partnership sharing profits and losses in the ratio of 7 : 3 respectively. As a mark of appreciation of the services of their manager Joshi, they admitted him into partnership on 1st April, 2008 giving him 1/10th share of the future profits; the mutual ratio between Pal and Singh remaining unchanged. Before becoming a partner, Joshi was getting a salary of Rs. 4,000 per month and a commission of 5% on the net profits remaining after charging his salary and commission. It was agreed that any excess over his former remuneration to which Joshi as a partner becomes entitled will be provided out of Pal's share of profit. The net profit for the year ended 31st March, 2009 amounted to Rs.19,80,000.

Prepare the profit and loss appropriation account for the year ended 31st March, 2009 showing the distribution of the net profits amongst the partners.

(8 marks)

- (b) The bank pass book of a trader showed an overdraft for Rs. 45,000 on 31st March, 2009 and a difference was noted when compared with the balance as per Cash Book. On a careful scrutiny the following facts were noticed :
- (a) Cheques deposited for Rs.75,000 but were not credited by the bank before 31st March, 2009.
- (b) Cheques issued for Rs. 38,500 were presented for payment on 4th April, 2009.
- (c) Bank column total of debit side of the cash book folio 36 for Rs. 6,59,500 was carried forward to the next folio as Rs. 5,69,500.

- (d) Withdrawal column of the bank pass book was added Rs.6,000 excess.
- (e) A cheque for Rs. 35,000 withdrawn from bank but recorded in the cash book as Rs. 53,000.
- (f) Bank charges Rs.1,500 debited by the bank but not recorded in cash book.

You are required to prepare a bank reconciliation statement as at 31st March, 2009 and ascertain the balance as shown by the cash book on that date.

(8 marks)

6. (a) While preparing the final accounts for the year ended 31st March, 2009 Mr. Suresh could not get his trail balance agreed. He transferred the difference to suspense account and prepared the final accounts. In April, 2009 the following errors were discovered in the books of account for the year 2008-09 :
- (i) The sales book for January, 2009 was under cast by Rs.2,000.
 - (ii) Entertainment expenses Rs.600 incurred on 5th February, 2009 were omitted to be posted from the cash book to the ledger.
 - (iii) Discount column on the receipt side of the cash book for February, 2009 was added as Rs.4,460 instead of Rs.4,260.
 - (iv) A purchase from Mr. Mahesh for Rs.16,400 on 3rd March, 2009 was correctly recorded in the purchases book. But the supplier was wrongly debited for the purchase.

Pass necessary journal entries to rectify the above mentioned errors without affecting the profit for the year 2009-10. Also prepare suspense account; and profit and loss adjustment account. Assume that all the errors have been located. (8 marks)

- (b) A fire occurred on 1st July, 2009 in the premises of German Traders and business was disorganized upto 30th November, 2009. From the books of account, the following information was extracted :

	Rs.
Actual turnover from 1st July, 2009 to 30th November, 2009	1,20,000
Turnover from 1st July, 2008 to 30th November 2008	4,00,000
Net profit for the last accounting year	1,80,000
Insured standing charges for the last accounting year	1,20,000
Turnover for the last accounting year	10,00,000
Turnover for the year ending 30th June, 2009	11,00,000
Total standing charges for the year	1,44,000

The company incurred additional expenses amounting to Rs.18,000 which reduced the loss in turnover. There was also a saving of Rs.4,900 during the indemnity period.

The company holds a 'loss of profit' policy for Rs.3,30,000 having an indemnity period of six months. There had been a considerable increase in trade and it had been agreed that an adjustment of 20% be made in respect of upward trend in turnover.

Compute claim under loss of profit insurance policy.

(8 marks)

7. Royal Cycle Co. of Punjab consigned 100 bicycles to General Cycle Traders of Agra costing Rs.1,500 each, invoiced at Rs.2,000 each. The consignor paid freight Rs.10,000 and insurance in transit Rs.1,500. During transit, 10 bicycles were totally damaged. General Cycle Traders took delivery of the remaining bicycles and paid Rs.1,530 for octroi duty. General Cycle Traders sent a bank draft to Royal Cycle Co. for Rs.50,000 as advance and later on sent an account sales showing that 80 bicycles had been sold @

Rs.2,200 each. Expenses incurred by General Cycle Traders on godown rent were Rs.2,000. General Cycle Traders is entitled to a commission of 5% on invoice price and 25% on any surplus of sale price over invoice price. Insurance claim was settled to Rs.14,000.

Prepare consignment account, consignee's account and accidental loss account in the books of the consignor.

(16 marks)

8. The trial balance of Tiwari as on 31st March, 2009 was as follows:

<i>Debit Balances</i>		<i>Rs. Credit Balances</i>	<i>Rs.</i>
Stocks on 1st April, 2008:		Sundry creditors	1,45,000
Raw materials	2,10,000	Bills payable	80,000
Work in progress	95,000	Sale of Scrap	25,000
Finished goods	1,55,000	Commission	4,500
Sundry debtors	2,40,000	Provision of	
Carriage on purchases	15,000	doubtful debts	16,500
Bills receivable	1,50,000	Capital account	8,85,000
Wages	1,10,000	Sales	18,72,000
Salaries	1,20,000		
Telephone, postage, etc.	13,500		
Repairs to plant	11,000		
Purchases	9,00,000		
Cash at bank	1,70,000		
Plant and machinery	6,50,000		
Office furniture	1,00,000		
Rent	60,000		
Lighting	13,500		
General expenses	15,000		
	<u>30,28,000</u>		<u>30,28,000</u>

The following additional information is available:

- (i) Stock on 31st March, 2009 were : *Rs.*

Raw materials	1,62,000
Finished goods	1,81,000
Semi-finished goods	78,000
- (ii) Salaries and wages outstanding for March, 2009 were Rs.18,000 and Rs.30,000 respectively.
- (iii) Machinery is to be depreciated by 10% and office furniture by 12%.
- (iv) Provision for doubtful debts is to be maintained @ 1% sales.
- (v) Office premises occupy 1/4th of total area. Lighting is to be charged as to 2/3rd to

factory and 1/3rd to Office.

Prepare the manufacturing account, trading account, profit and loss account for the year ended 31st March, 2009 and the balance sheet as on 31st March, 2009.

(16 marks)

FOUNDATION PROGRAMME
FINANCIAL ACCOUNTING

QUESTION PAPERS OF PREVIOUS SESSIONS

Question papers of immediate past two examinations of Financial Accounting paper are appended to this study material for reference of the students to familiarize with the pattern and its structure. Students may please note that answers to these questions should not be sent to the Institute for evaluation.

JUNE 2010

Time allowed : 3 hours

Maximum marks : 100

NOTE: Answer SIX questions including Question No.1 which is COMPULSORY. All working notes should be shown distinctly.

1. (a) Explain **any two** of the following :
 - (i) Combined journal entries
 - (ii) Sub-division of journal
 - (iii) Balancing ledger accounts
 - (iv) Accommodation bill. (5 marks each)
- (b) State, with reasons in brief, whether the following statements are correct or incorrect :
 - (i) Depreciation cannot be provided if there is a loss in a financial year.
 - (ii) Trial balance ensures the arithmetical accuracy of the ledger.
 - (iii) Account sale is a statement sent by the consignor to the consignee.
 - (iv) Wages paid for erection of machinery are debited to profit and loss account.
 - (v) Receipts and payments account is a summary of all capital receipts and capital payments. (2 marks each)
2. (a) Re-write the following sentences after filling-in the blank spaces with appropriate word(s)/figure(s) :
 - (i) No depreciation has been charged on machinery. This is an error of _____.
 - (ii) Valuation of closing stock in hand is done at the lower of _____ and _____.
 - (iii) Payments recorded in the petty cash book are posted in _____ to ledger accounts.
 - (iv) Closing capital is Rs.4,00,000 and opening capital is Rs.3,00,000, but profit ascertained is Rs.1,40,000. There must have been net _____ of Rs.40,000

during the year.

- (v) If a suspense account has been opened, every one-sided error is rectified by passing a journal entry through _____ account.
 - (vi) Trade discount is deducted from the _____ price.
 - (vii) When a bill receivable is dishonoured, the amount of the bill is debited to the _____ account.
 - (viii) The period of indemnity in case of fire insurance claims generally does not exceed _____. (1 mark each)
- (b) Distinguish between **any two** of the following :
- (i) 'Cash discount' and 'trade discount'.
 - (ii) 'Bill of exchange' and 'promissory note'.
 - (iii) 'Trial balance' and 'balance sheet'. (4 marks each)
3. (a) Choose the most appropriate answer from the given options in respect of the following :
- (i) Opening entry is passed with —
 - (a) Balances from trial balance
 - (b) Balances from the last year's balance sheet
 - (c) Items of trading account
 - (d) Items of profit and loss account.
 - (ii) The following error would not affect the profit —
 - (a) Goods sold to Ram, debited to Mohan
 - (b) Sales book was undercast by Rs.1,000
 - (c) A purchase of Rs.400 was wrongly written as Rs.40 in purchases book
 - (d) Expenses of plant repairs debited to plant account.
 - (iii) Which one of the following accounting concepts treats owner of the business as creditor of the business —
 - (a) Going concern concept
 - (b) Historical cost concept
 - (c) Business entity concept
 - (d) Realisation concept.
 - (iv) The process of entering transactions in the ledger is called —
 - (a) Journalising
 - (b) Posting
 - (c) Summarising
 - (d) Balancing.
 - (v) If a payment is made on a bill on due date, then it is called —
 - (a) Honouring of the bill
 - (b) Retiring of the bill
 - (c) Dishonouring of the bill
 - (d) Renewal of the bill.
 - (vi) Trading account is a part of —
 - (a) Trial balance
 - (b) Cash book
 - (c) Final accounts
 - (d) Journal.

- (vii) Revaluation account is prepared to find out the profit or loss on —
- Sale of fixed assets
 - Revaluation of assets and liabilities
 - Sale of goods
 - Sale of services.
- (viii) When depreciation is charged equally year after year, it is known as—
- Fixed instalment method
 - Diminishing balance method
 - Depreciation fund method
 - Annuity method. (1 mark each)

(b) Explain **any two** of the following statements :

- In the absence of partnership deed, provisions of the Indian Partnership Act, 1932 are applied.
- Single entry system of book keeping is unscientific, incomplete and defective system.
- Every transaction has debit and credit aspects. (4 marks each)

4. (a) Rim Zim Ltd. maintains a current account with the State Bank of India. On 31st March, 2010, the bank column of its cash book showed a debit balance of Rs.1,54,300. However, the bank statement showed a different balance as on that date. The following were the reasons for the difference :

Rs.

- | | |
|--|----------|
| (i) Cheques deposited, but not yet credited by the bank | 75,450 |
| (ii) Cheques issued, but not yet presented for payment | 80,760 |
| (iii) Bank charges not yet recorded in the cash book | 1,135 |
| (iv) Cheques received by the bank directly from trade debtors | 1,35,200 |
| (v) Insurance premium paid by the bank as per standing instructions, but not yet recorded in the cash book | 15,400 |
| (vi) Dividend collected by the bank, but not yet recorded in the cash book | 1,000 |

Find out the balance as per the bank statement as on 31st March, 2010.

(8 marks)

(b) On 1st April, 2005, a company acquired a lease of land for a term of 5 years at a cost of Rs.4,00,000. It is proposed to depreciate the lease by annuity method charging 5% per annum interest.

Show the lease account for the entire period of 5 years. A reference to the annuity tables shows that to depreciate Re.1 by annuity method over 5 years, charging 5% per annum interest, one must write off a sum of Re.0.230975 every year. (8 marks)

5. (a) Amar, Akbar and Anthony were carrying on a business in partnership, sharing profits and losses in the ratio of 2:1:1 respectively. They took a joint life policy for Rs.1,20,000 on 1st April, 2006. The annual premium of Rs.5,000 was payable on 1st May every year. The last premium was paid on 1st May, 2009. Akbar died on 10th June, 2009 and policy money was received on 31st July, 2009.

The surrender values of the policy as on 31st March in different years were as follows :

- 2007 – Nil;
- 2008 – Rs.1,000; and
- 2009 – Rs.1,600.

Prepare joint life policy account for the entire period assuming that the joint life policy was maintained at its surrender value and the accounts were closed on 31st March every year. (8 marks)

- (b) The following information is available from Sachin, who maintains books of account on single entry system :

Particulars	On 1st April, 2009 (Rs.)	On 31st March, 2010 (Rs.)
Cash and bank	20,000	21,000
Sundry debtors	17,000	25,000
Stock	40,000	60,000
Furniture	29,000	29,000
Sundry creditors	32,000	22,000
10% Loan from Mrs. Sachin	30,000	30,000

Sachin withdrew Rs.5,000 from the business every month for meeting his household expenses. During the year, he sold investments held by him privately for Rs.35,000 and invested the amount in his business.

At the end of the year 2009-10, it was found that full year's interest on loan from Mrs. Sachin had not been paid. Depreciation @ 10% per annum was to be provided on furniture for the full year. Shop assistant was to be given a share of 5% on the profits ascertained before charging such share.

Calculate profit earned during the year ended 31st March, 2010 by Sachin. (8 marks)

6. The following is the summary of the cash transactions of a literary society for the year ended 31st March, 2010 :

Rs.	Rs.	
Cash balances on 1st April, 2009	31,900	Rent and rates 16,800
Entrance fees	25,500	Wages 24,500
Subscriptions	1,60,000	Lighting 7,200
Donations	16,500	Lecture fees 43,500
Life membership		Books 21,300
subscription	25,000	Office expenses 45,000
Interest on fixed deposit	1,200	Fixed deposit @ 6% per annum on 1st October, 2009 80,000
Profit from entertainment	4,400	Cash at bank on 31st March, 2010 24,200
	Cash in hand on 31st March, 2010	<u>2,000</u>
	<u>2,64,500</u>	<u>2,64,500</u>

At the beginning of the year, the society possessed books worth Rs.2,00,000 and furniture valued at Rs.85,000. Ordinary subscriptions in arrear at the beginning of the year amounted to Rs.3,500 and at the end of the year Rs.4,500. Six months' rent, Rs.6,000 was due both at the beginning and at the end of the year. Provide Rs.5,000 as depreciation on furniture and Rs.11,300 as depreciation on books.

Prepare the society's income and expenditure account for the year ended 31st March, 2010 and its balance sheet as on that date. (16 marks)

7. From the following balances extracted from the books of Karan and the additional information, prepare the trading and profit and loss account for the year ended 31st March, 2010 and also show the balance sheet as on that date :

Debit Balance	Credit Balance
(Rs. '000)	(Rs. '000)

Stock on 1st April, 2009	625	—
Purchases and sales	903	1,372
Returns	22	13
Capital account	—	300
Drawings	45	—
Land and buildings	300	—
Furniture and fittings	80	—
Trade debtors and trade creditors	250	450
Cash in hand	35	—
Investments	100	—
Interest	—	5
Commission	—	30
Direct expenses	75	—
Postage, stationery and telephone	25	—
Fire insurance premium	20	—
Salaries	90	—
Bank overdraft	—	400
	<u>2,570</u>	<u>2,570</u>

Additional information :

- (i) Closing stock on 31st March, 2010 is valued at Rs.6,50,000. Goods worth Rs.5,000 are reported to have been taken away by the proprietor for his personal use at home during the year.
 - (ii) Interest on investments Rs.5,000 is yet to be received while Rs.10,000 of the commission received is yet to be earned.
 - (iii) Rs.5,000 of the fire insurance premium paid is in respect of the quarter ending 30th June, 2010.
 - (iv) Salaries Rs.10,000 for March, 2010 and bank overdraft interest estimated at Rs.20,000 are yet to be recorded as outstanding charges.
 - (v) Depreciation is to be provided on land and buildings @ 5% per annum and on furniture and fittings @ 10% per annum.
 - (vi) Make a provision for doubtful debts @ 5% of trade debtors. (16 marks)
8. (a) Ajoy of Agra and Bijoy of Bijnor enter into a joint venture to consign 200 bales of cloth to Dinesh of Delhi to be sold on their joint risk which is in the proportion of 3/7 and 4/7 respectively. Ajoy sends 150 bales of cloth at Rs.2,600 each, paying freight and other charges Rs.4,900. Bijoy sends 50 bales of cloth at Rs.2,500 each, paying expenses amounting to Rs.3,600. All the bales of cloth are sold by Dinesh for Rs.14,00,000 out of which Dinesh deducts Rs.6,000 for expenses and 10% on total sales as his commission. Dinesh remits Rs.3,00,000 to Ajoy and the balance to Bijoy through bank drafts.
- Prepare joint venture account and the accounts of Bijoy and Dinesh in Ajoy's ledger. (8 marks)
- (b) A merchant closes his books every year on 31st March. A fire occurred in his premises on 16th May, 2009 and stock costing Rs.38,000 only could be salvaged. Using the following additional information, prepare a statement showing the amount of claim to be lodged with the insurance company :

Particulars	2006-07	2007-08	2008-09	1-4-2009 to 16-5-2009
	(Rs.)	(Rs.)	(Rs.)	(Rs.)
Opening stock	1,50,300	1,40,300	1,58,200	1,60,000

Purchases	4,40,000	5,12,900	5,86,800	78,000
Sales	6,00,000	6,60,000	7,80,000	99,200
Closing stock	1,40,300	1,58,200	1,60,000	?

(8 marks)

DECEMBER 2010

Time allowed : 3 hours

Maximum marks : 100

NOTE: Answer SIX questions including Question No.1 which is **COMPULSORY**. All working notes should be shown distinctly.

1. (a) Explain **any two** of the following :
 - (i) Error of principle
 - (ii) Garner vs. Murray rule
 - (iii) Accounting equation
 - (iv) Loss of profits insurance policy. (5 marks each)
- (b) State, with reasons in brief, whether the following statements are true or false :
 - (i) While profit and loss account pertains to a point of time, the balance sheet is concerned with a period of time.
 - (ii) Change in selling price is the only reason responsible for a change in gross profit.
 - (iii) Being invisible, goodwill is a fictitious asset.
 - (iv) A joint venture adheres to the going concern concept.
 - (v) Receipts and payments account is based on accrual concept.

(2 marks each)
2. (a) Re-write the following sentences after filling-in the blanks spaces with appropriate word(s)/figure(s) :
 - (i) Each transaction has two aspects, debit and credit; this fact is known as _____ concept.
 - (ii) _____ account is prepared to ascertain the cost of goods manufactured.
 - (iii) The total of purchases book is periodically posted to the _____ of purchases account.
 - (iv) The relationship between the consignor and the consignee is that of a _____ and an agent.
 - (v) Partnership business is carried on in the name of the _____.
 - (vi) Depletion method of depreciation is applicable in case of _____ assets.
 - (vii) On dishonour of a bill of exchange, the noting charges have to be ultimately borne by the _____ of the bill.
 - (viii) Outstanding rent account is a _____ account.

(1 mark each)
- (b) Distinguish between **any two** of the following :
 - (i) 'Journal' and 'ledger'.
 - (ii) 'Statement of affairs' and 'balance sheet'.
 - (iii) 'Capital expenditure' and 'revenue expenditure'. (4 marks each)
3. (a) Choose the most appropriate answer from the given options in respect of the following :
 - (i) Amount spent on an advertising campaign to launch a new product is —
 - (a) Capital expenditure
 - (b) Revenue expenditure
 - (c) Deferred revenue expenditure
 - (d) Income.
 - (ii) Rs. 10,000 receivable from Sohan were written off as bad debt. Now, a sum of

Rs.5,000 is received from Sohan's estate as the first and final dividend. The amount received should be credited to —

- (a) Bad debts recovered account
- (b) Sohan
- (c) Cash account
- (d) Bad debts account.

(iii) If the profit is 25% of the cost price, then it is —

- (a) $33\frac{1}{3}\%$ of the selling price
- (b) 25% of the selling price
- (c) 20% of the selling price
- (d) $12\frac{1}{2}\%$ of the selling price.

(iv) Balance sheet discloses —

- (a) Cash transactions of the business
- (b) Financial position of the business
- (c) Calculation of income of the business
- (d) Profit earning capacity of the business.

(v) Principle of mutual agency is applicable in case of —

- (a) Consignor and consignee
- (b) Partners of a firm
- (c) Insurer and insured
- (d) Drawer and acceptor of a bill of exchange.

(vi) After adding three days of grace period, the date of maturity of a bill of exchange falls on 26th January. The effective due date of the bill will be —

- (a) 25th January
- (b) 26th January
- (c) 27th January
- (d) 29th January.

(vii) Under single entry system, normally only one subsidiary book is maintained, namely —

- (a) Cash book
- (b) Purchases book
- (c) Sales book
- (d) Journal proper.

(viii) Under single entry system, if a ledger is at all maintained, one can expect in it accounts of only —

- (a) Assets
- (b) Trade debtors and trade creditors
- (c) Outstanding liabilities
- (d) Incomes and expenses.

(1 mark each)

(b) Explain **any two** of the following statements :

- (i) Depreciation is a process of allocation and not of valuation.
- (ii) Dissolution of a partnership need not necessarily lead to the dissolution of the firm.
- (iii) Agreement of a trial balance is not a conclusive proof that there are no errors in the books of account. *(4 marks each)*

4. Suman of Surat consigned to his agent Puneet of Pune goods invoiced at Rs.1,20,000 which was 20% above cost. Suman spent Rs.6,000 on packing, cartage, freight and insurance in transit. Puneet accepted a bill of exchange for Rs.70,000 at one month drawn on him by Suman.

The terms of consignment were that the consignee would be allowed 5% commission on sales and all expenses incurred by him would be reimbursed.

The consignee sold 4/5th of the goods for Rs. 1,03,000 incurring cash selling expenses amounting to Rs.4,700. Goods of the invoice price of Rs.6,000 were damaged due to negligence of the consignee. These goods were sold for Rs.2,800. It was agreed that the consignee would not be entitled to any commission on this amount.

Puneet agreed to take the remaining goods himself at 10% above invoice price without charging any commission on the amount. He settled the account by means of a bank draft.

Prepare the necessary ledger accounts in the books of the consignor.

(16 marks)

5. (a) On 30th June, 2010, the pass book of Nataraj showed a bank overdraft of Rs.46,000. The following additional information is available. You are required to prepare a bank reconciliation statement as on the above mentioned date:
- (i) Out of total cheques issued, cheques for Rs. 22,000 have not been presented for payment so far.
 - (ii) Cheques paid into bank for collection, but not yet cleared total Rs. 31,000.
 - (iii) Bank has charged Rs. 2,300 as interest on overdraft; it does not appear in cash book.
 - (iv) A customer has directly deposited Rs.8,300 with bank in Nataraj's account for which there is no entry in cash book.
 - (v) Dividend on shares collected by bank and credited in the pass book amounts to Rs.2,000 for which no intimation has been given to Nataraj so far.
 - (vi) A bill for Rs. 10,000 discounted with the bank was dishonoured on maturity. Bank has debited Nataraj with Rs.10,100 including Rs.100 for noting charges, the transaction has not yet been recorded in cash book. *(8 marks)*
- (b) The books of Ramesh did not agree. The difference of Rs.12,700 in trial balance was placed to the debit of suspense account. Subsequently, the following errors were located. Pass journal entries to rectify the errors and prepare the suspense account:
- (i) The total of the purchases returns book, Rs. 2,100 has not been posted.
 - (ii) A sale of Rs. 4,300 to Ram has been credited to his account as Rs. 3,400.
 - (iii) A purchase from Suresh for Rs. 4,000 has been entered in the sales book. However, Suresh has been correctly credited with Rs. 4,000.
 - (iv) Old furniture sold on credit for Rs. 5,400 has been recorded in the sales book as Rs. 4,500.
 - (v) Goods taken away by Ramesh, the proprietor for his personal use worth Rs.750 have not been recorded in the books of account at all.

(8 marks)

6. Amar, Bharat and Chatur were equal partners. On 31st March, 2010, their

balance sheet stood as follows :

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Capital accounts :		Building	1,95,000
Amar	1,68,000	Furniture	24,000
Bharat	1,26,000	Stock	1,14,000
Chatur	60,000	Debtors	1,08,000
Creditors	70,000	Cash at bank	6,000
Bills payable	<u>23,000</u>		
<u>4,47,000</u>		<u>4,47,000</u>	

On 1st April, 2010, the firm decided to admit Dalbir as an equal partner on the following terms :

- (i) Dalbir would bring Rs.90,000 as his share of goodwill and Rs.1,50,000 as capital. No goodwill account would be opened.
- (ii) 10% Depreciation be charged on furniture.
- (iii) 5% Provision for doubtful debts be created on debtors.
- (iv) A liability of Rs.7,200 be created against bills discounted.
- (v) Building be valued at Rs.2,70,000.

Pass necessary journal entries. Also prepare revaluation account and the capital accounts of all the partners. (16 marks)

7. (a) A fire occurred on the premises of a merchant on 31st August, 2010. From the following particulars, calculate the amount of claim to be lodged with the insurance company for the loss of stock :

	<i>Rs.</i>
Stock on 1st April, 2009	3,60,000
Purchases for the year ended 31st March, 2010	16,00,000
Sales for the year ended 31st March, 2010	25,00,000
Stock on 31st March, 2010	4,40,000
Purchases from 1st April, 2010 to 31st August, 2010	5,40,000
Sales from 1st April, 2010 to 31st August, 2010	6,60,000

Stock on 1st April, 2009 was valued at 10% below cost and the stock on 31st March 2010 was valued at 10% above cost. Salvage value of stock after fire was Rs. 99,600. Value of insurance policy of the stock was Rs.3,00,000. (8 marks)

- (b) On 1st January, 2010, Arun purchased from Barun goods invoiced at Rs. 10,000. On the same date, Barun drew upon Arun a bill for the amount at 2 months and Arun accepted the same. On 4th January, 2010, Barun got the bill discounted with his bank @ 12% per annum. On due date, Arun told Barun that he was not in a position to pay the full amount and requested Barun to accept Rs.5,000 in cash and drew a fresh bill at 2 months for the remaining amount plus interest at 15% per annum. Barun agreed. The second bill was duly met on the due date.

Give journal entries to record the above transactions in the books of Barun. (8 marks)

8. (a) On 1st April, 2007, Brite Ltd. purchased a machine for Rs. 1,50,000 and spent Rs.30,000 on its installation. On 1st October, 2008, a new machine was purchased at a cost of Rs. 1,20,000. On 30th June, 2009, the first machine got damaged and was sold as scrap for Rs.25,000. On 1st July, 2009, the machine was replaced by a new machine purchased for Rs.2,60,000 and a sum of Rs.40,000 was spent on its installation.

Show machinery account for the three years ended 31st March, 2010 while charging depreciation @ 10% per annum as per the written down value method. Accounts of

Brite Ltd. are closed every year on 31st March. (8 marks)

- (b) From the following information, calculate the amount of subscriptions that will appear on the credit side of income and expenditure account for the year ended 31st March, 2009. Also show how the items would appear in the opening balance sheet as on 31st March, 2008 and the closing balance sheet as on 31st March, 2009.

- (i) Subscription received during the year ended 31st March, 2009 :

	Rs.
For 2007-08	4,000
For 2008-09	2,05,000
For 2009-10	<u>6,000</u>
	<u>2,15,000</u>

- (ii) There are 500 members and annual subscription is Rs.500 per member.
(iii) On 31st March, 2009, Rs.5,000 was still in arrears for subscriptions for the year ended 31st March, 2008. (8 marks)
-