Uttar Pradesh Rajarshi Tandon Open University

Bachelor of Business Administration

BBA-106

Financial Accounting

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BLOCK

1

ACCOUNTING FUNDAMENTAL

UNIT-1

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UNIT-01 BASIC CONCEPTS OF ACCOUNTING

Objectives :

After going through this unit, you must be able to:

- Explain the meaning of accounting
- Identify the objectives of accounting
- Differentiate between accounting concepts and conventions
- Know the rules of Debit and Credit applicable to different types of business transaction
- Describe the different systems of accounting

Structure :

1.1 ACCOUNTING – AN OVERVIEW

Accounting is the production of information about an enterprise and the transmission of that information from people who have it to those who need it. The communication is generally in the form of financial statements that show in money terms the economic resources under the control of management; the art lies in selecting the information that is relevant to the user and is representationally faithful. The principles of accountancy are applied to business entities in three divisions of practical art, named accounting, book-keeping, and auditing.

Accounting is thousands of years old; the earliest accounting records, which date back more than 7,000 years, were found in Mesopotamia (Assyrians). The people of that time relied on primitive accounting methods to record the growth of crops and herds. Accounting evolved, improving over the years and advancing as business advanced. Early accounts served mainly to assist the memory of the businessperson and the audience for the account was the proprietor or record keeper alone. Cruder forms of accounting were inadequate for the problems created by a business entity involving multiple investors, so double-entry bookkeeping first emerged in northern Italy in the 14th century, where trading ventures began to require more capital than a single individual was able to invest. The development of joint-stock companies created wider audiences for accounts, as investors without first hand knowledge of their operations relied on accounts to provide the requisite information. This development resulted in a split of accounting systems for internal (i.e. management accounting) and external (i.e. financial accounting) purposes, and subsequently also in accounting and disclosure regulations and a growing need for independent attestation of external accounts by auditors. Today, accounting is called "the language of business" because it is the vehicle for reporting financial information about a business entity to different groups of people.

1.1.1 OBJECTIVES OF ACCOUNTING

The broad objects of Accounting may be briefly stated as follows:

1. To keep systematic record: Accounting keeps a systematic record of all financial transactions on any given day
2. To maintain various other Journals for recording day-to-day non cash transactions.
3. To maintain various Ledger Accounts to find out the exact amounts of incomes and expenses or gains and losses or receivables and payables.
4. To find out the net profit or net loss or surplus or deficit for any particular period.
5. To find out the total capital, positions of assets and liabilities on a particular date.
6. To confirm about the arithmetical accuracy of the books of accounts.

7 To help the management by supplying accounting ratios, reports and relevant data.

8 To calculate the cost of production.

9 To help the management formulate policies for controlling cost, preparation of quotation for competitive supply etc.

1.1.2 DEFINITION AND SCOPE OF ACCOUNTING

Many accountants have defined Accounting in different ways:

H.Chakravorty: "Accountancy is the science of recording, classifying and summarizing transactions so that relation with outsiders is exactly determined and result of operation during a particular period can be calculated, and the financial position at the end of the period may be shown.
In 1941, The American Institute of Certified Public Accountants [A.I.C.P.A.] defined it. "Accountancy may be defined as the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are in part, at least of financial character, and interpreting the results thereof".

In 1966, the American Accounting Association [AAA] defined accounting as "the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information"

According to Taylor and Shearing: "Accounting may be defined as the art and science of recording business transactions in a methodological manner so as to show: (a) the true state of affairs of a business of a particular period of time and, (b) the surplus or deficiency which has accrued during a specific period."

Scope of Accounting

Accounting has got a very wide scope and area of application. Its use is not confined to the business world alone, but spread over in all the spheres of the society and in all professions. Now-a-days, in any social institution or professional activity, whether that is profit earning or not, financial transactions must take place. So there arises the need for recording and summarizing these transactions when they occur and the necessity of finding out the net result of the same after the expiry of a certain fixed period. Besides, there is also the need for interpretation and communication of those information to the appropriate persons. Only accounting can help overcome these problems.

In the modern world, accounting system is practised not only in all the business institutions but also in many- non trading institutions like Schools, Colleges, Hospitals, Charitable Trusts, Clubs, Co operative Society etc. and also Government and Local Self-Government in the form of Municipality, Panchayat. The professional persons like Medical practitioners, practising Lawyers, Chartered Accountants etc. also adopt some suitable types of accounting methods. As a matter of fact, accounting methods are used by all who are involved in a series of financial transactions.

The scope of accounting as it was in earlier days has undergone lots of changes in recent times. As accounting is a dynamic subject, its scope and area of operation have been always increasing keeping pace with the socio-economic changes. As a result of continuous research in this field the new areas of application of accounting principles and policies have emerged. National Accounting, Human Resources Accounting and Social Accounting are examples of the new areas of application of accounting systems.

1.1.3 ACCOUNTING AND ACCOUNTANCY

Accountancy is the art of communicating financial information about a business entity to users such as shareholders and managers. Accountancy is a branch of mathematical science that is useful in discovering the causes of success and failure in business. The principles of accountancy are applied to business entities in three divisions of practical art, named accounting, bookkeeping, and auditing. Principles and practices used in the business environment is know as Accounting. Accounting is a system of financial information collected every day in a company. This process provides information about a company's financial situation. This includes recording financial information and putting it into financial statements for the internal or external users.

1.1.4 PARTIES INTERESTED IN ACCOUNTING INFORMATION

The basic objective of accounting is to provide information, which is useful to the people inside and outside the organization.

a.) Internal Users

Owners/investors: They are the major recipients of the financial statements of business enterprises. As providers of risk capital, the individual and institutional investore [such as insurance companies and mutual funds] are accountable to the risk inherent in, and returns provided by their investments. They need information to decide which investments to buy, retain or sell and the timing of the purchases or sales of those investments.

Management- Management needs information for planning and controlling operations, for making special decisions, and for formulating major plans and policies.

Employees: They are interested in information about the enterprise as well as its general operations, financial affairs, stability and profitability, since it is the main source of their income.

b.) External Users

Lenders: Lenders such as banks and debentures-holders, need to know about the financial stability of a business that approaches them for funds. They are interested in information that enables them to determine whether their loans and the related interest will be regularly and duly received.

Suppliers and other trade creditors Present and potential suppliers are interested in the enterprise as an outlet for their products or services and if the enterprise is a major customer, they would like to assess the future scenario. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuation of the enterprise as a major customer

Government and regulatory agencies: Government are interested in the allocation of resources and the activities of enterprises. They also require information in order to regulate the business practices of enterprise, determine taxation policies and provide a basis for national income and similar statistics. Quasi government regulatory bodies such as SEBI, IRDA, stock exchange have a legitimate interest in financial reports of publicly held enterprises to ensure the efficient operation of capital markets.

Customers: Customers are interested in the financial affairs of an enterprise to decide how much business to do with it, and to assess its ability to service the product or to honour warranty agreements.

The public: Financial statements assist the public by providing information about the trends and recent developments in the prosperity of an enterprise and the range of its activities.

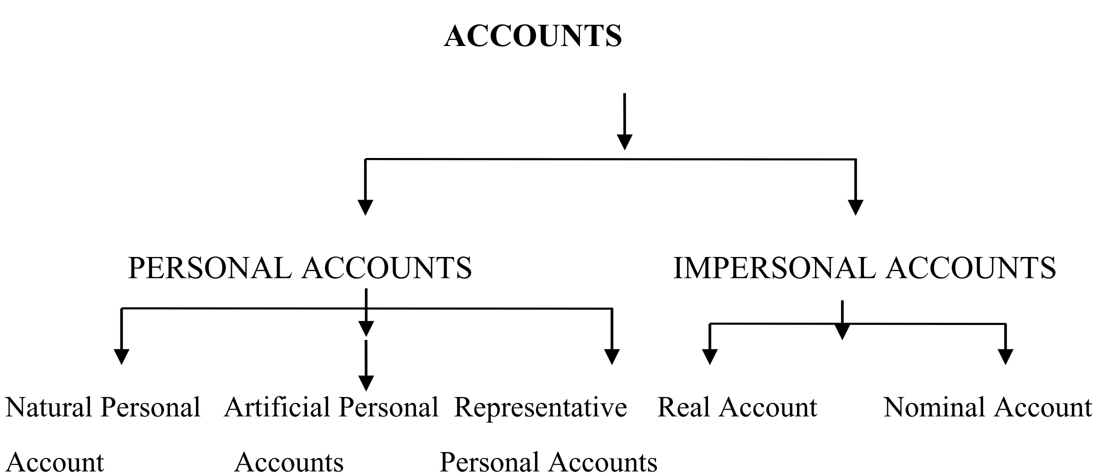
Researchers: Being a mirror of the financial performance of a business organization, financial statements are of immense value to a researcher who wants to study the financial operations of a particular firm.

1.1.5 CLASSIFICATION OF ACCOUNTS

All accounts may be grouped in two broad categories or classifications. These are personal and impersonal.

Personal Accounts: These are the accounts that have the names of debtors (customers) or creditors (suppliers). They are, therefore, personal to this extent.

Impersonal Accounts These non personal accounts may be divided into Real Accounts and Nominal Accounts.



Personal Accounts: They include the accounts of person with whom the business deals. These accounts can be classified into three categories:

i. **Natural personal accounts**: This term is meant for persons, who are the creation of God, for example, Ram's account , Raja's account.

ii. **Artificial personal account**: These accounts include account of corporate bodies or institutions which are recognised as persons in business dealing, for example, the accounts of a limited company, a cooperative society, LIC, SBI and so on.

iii. **Representative personal accounts**: These are accounts which represent a certain person or a group of persons, e.g. rent due to landlord and salary due to the employee.

Real Account: Real accounts may be of the following types:

i. **Tangible real accounts**: These are related to such things which can be touched, felt, and measured, e.g. cash account, land, building account and so on.

ii. **Intangible accounts**: These accounts represent such things which cannot be touched, they can be measured only in terms of money, e.g. goodwill, patent, copyright etc.

Nominal Account: Nominal accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. This account includes accounts of all expenses, losses, incomes, and gains.

1.1.6 BRANCHES OF ACCOUNTING

In order to satisfy the needs of the different people interested in the accounting information, various branches of accounting have developed.

Financial Accounting:

Financial accounting is the periodic reporting of a company's financial position and the results of operations to external parties through financial statements, which ordinarily include the balance sheet (statement of financial position), income statement (the profit and loss statement), andstatemen t of cash flows. Financial statements are relied upon by suppliers of capital,- e.g., shareholders, bondholders and banks as well as customers, suppliers, government agencies and policymakers.

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 primary functions of cost accounting are to ascertain the cost of a product and to help the management in the control of cost. Cost accounting is that branch of accounting which deals with the classification, recording, allocation, suumarization and reporting of current and prospective costs.

Management Accounting:

Where financial accounting focuses on external users, management accounting emphasizes the preparation and analysis of accounting information within the organization. According to the Institute of Management Accountants, it includes "…designing and evaluating business processes, budgeting and forecasting, implementing and monitoring internal controls, and analyzing, synthesizing and aggregating information…to help derive economic value.".

1.1.7 ADVANTAGES OF ACCOUNTING

The advantages of accounting can be enumerated as follows:

Maintenance of business records All financial transactions are recorded in a systematic manner in the books of account so that there is no need to rely on memory.

Preparation of financial statements: Systematic records enable the accountant to prepare the financial statement- trading and profit & loss account to calculate profit or loss during a particular accounting period and balance sheet to state the financial position of the business on a particular date.

Comparison of results: Systematic maintenance of business records enables the accountant to compare profit of one year with those of earlier years to know the significant facts about the changes. This helps the business to plan its future affair accordingly.

Decision –making: For day to day solving of a number of problems, the accountant helps the management by providing the relevant information for decision-making.

Planning and control operations: Planning operations like sales, production cash requirements for next accounting periods are achieved with the help of accounting information and estimates based on that information. Management is also interested in observing that the operations in the business are going on according to plan and all the departments are spending within their prescribed limits.

Provides information to interested groups: Various parties or groups like creditors, owners, government, management, employees are interested in accounting information related to sales, production , profit etc. Accounting provides suitable information to such interested parties.

Taxation problems: In the settlement of taxation matters, systematic maintenance of records is a big help.

Valuation of business: Accounting records kept in a proper way enable a business unit to determine the purchase or sale price in a simple manner.

1.1.8 LIMITATIONS OF ACCOUNTING

Monetary nature: Accounting records only those transactions which are measured in terms of money. The items like product quality, government policy competitive strategies and so on, though will have direct bearing on the business, will not be recorded in the books of accountant.

Historical data: Financial accounting records only those transactions which have occurred. Management planning and decisions are future-oriented, hence they require information about the future. Financial accounting fails to provide such future information.

Preparation of accounts: Accounting does not record financial data unit-wise, product-wise or process-wise. So it is difficult for the management to know the unit cost or the total cost of a product.

Actual cost alone is recorded: Assets and Liabilities are recorded at the cost in the books. Since price level changes are not accommodated in this account, the price comparison of various years becomes difficult.

Fails to help price fixation: Since financial accounts record historical data, the cost of production can be ascertained only after the costs are incurred, so the prices of the products cannot be fixed in advance

Not useful in cost control: The cost control process involves constant comparison of predetermined cost with actual cost. If costs are incurred and information is available subsequently, nothing can be done to control them.

1.2 BASIC ACCOUNTING CONCEPTS

Accounting is a system evolved to achieve a set of objectives and in order to achieve these objectives we maintain systematic record of all business transactions and prepare annual reports for the interested parties. Any activity that you perform is facilitated if you have a set of rules to guide you. In accounting, certain rules and conventions have been adopted which serve as guidelines in identifying the events and transactions to be accounted for, measuring them, recording them in books of account, summarising them, and reporting them to the interested parties. These rules and conventions are termed as 'Generally Accepted Accounting Principles'. To explain these principles, the authors have used a variety of terms such as concepts, postulates, conventions, underlying principles, basic assumptions, etc. These concepts can be classified into two broad groups as follows:

i) Concepts to be observed at the recording stage i.e., while recording the transactions, and

ii) Concepts to be observed at the reporting stage i.e., at the time of preparing the final accounts.

1.2.1 CONCEPTS TO BE OBSERVED AT THE RECORDING STAGE

Following are the concepts under this category:

i. **Business Entity Concept:**Financial accounting is based on the premise that the transactions and balances of a business entity are to be accounted for separately from its owners. The business entity is, therefore, considered to be distinct from its owners for the purpose of accounting. Therefore, any personal expenses incurred by owners of a business will not appear in the income statement of the entity. Similarly, if any personal expenses of owners are paid out of assets of the entity, it would be considered to be drawings for the purpose of accounting much in the same way as cash drawings.

The business entity concept also explains why owner's equity appears on the liability side of a balance sheet. Capital contributed by a sole trader to his business, for instance, represents a form of liability (known as equity) of the 'business' that is owed to its owner which is why it is presented on the liabilities side of the balance sheet.

ii. **Going Concern Concept**: Going concern is one of the fundamental assumptions in accounting on the basis of which financial statements are prepared. Financial statements are prepared assuming that a business entity will continue to operate in the foreseeable future without the need or intention on the part of management to liquidate the entity or to significantly curtail its operational activities. Therefore, it is assumed that the entity will realize its assets and settle its obligations in the normal course of the business. The 'Going Concern Concept' does notyimp permanent continuance of the enterprise. It rather presumes that the enterprise will continue in operation long enough to charge against income, the cost of fixed assets over their useful lives, to amortize over appropriate period other costs which have been deferred under the matching concept, to pay liabilities when they become due and to meet the contractual commitments. Moreover, the concept applies to the business as a whole. When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going concern is normally not impaired. The enterprise will not be considered as a going concern when it has gone into liquidation or it has become insolvent. Of course, the receiver or the liquidator may endeavour to carry on business operations for some period pending arrangement with the creditors or final buyer for the sale of the business as a going concern, the going concern status of the concern will stand terminated from the date of his appointment or will be at least regarded as suspended, pending the results of his efforts.

iii. **Money Measurement Concept**: Money Measurement Concept in accounting, also known as Measurability Concept, means that only transactions and events that are capable of being measured in monetary terms are recognized in the financial statements. All transactions and events recorded in the financial statements must be reduced to a unit of monetary currency. Where it is not possible to assign a reliable monetary value to a transaction or event, it shall not be recorded in the financial statements.However, any material transaction and event that is not recorded for failing to meet the measurability criteria might need be disclosed in the supplementary note to financial statements to assist the users in gaining a better understanding of the financial performance and position of the entity.

iv. **Cost Concept**: Cost concept states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them. It may be clarified that cost means original or acquisition cost only for new assets and for the used ones, cost means original cost less depreciation. The cost concept is also known as historical cost concept. The effect of cost concept is that if the business entity does not pay anything for acquiring an asset, this item would not appear in the books of accounts. Thus, goodwill appears in the accounts only if the entity has purchased this intangible asset for a price.

v. **Dual Aspect Concept**: Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation :

Assets = Liabilities + Capital

The above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders. This claim is also termed as capital or owners' equity and that of outsiders, as liabilities or creditors' equity. The knowledge of dual aspect helps in identifying the two aspects of a transaction which help in applying the rules of recording the transactions in books of accounts. The implication of dual aspect concept is that every transaction has an equal impact on assets and liabilities in such a way that total assets are always equal to total liabilities.

vi. **Realization concept:** This concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not. In other words, it can be said that Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created.

vii. **Accrual concept:** The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses. In brief, accrual concept requires that revenue is recognised when realised and expenses are recognised when they become due and payable without regard to the time of cash receipt or cash payment.

viii. **Matching concept**: This is based on the accounting period concept. The paramount objective of running a business is to earn profit. In order to ascertain the profit made by the business during a period, it is necessary that 'revenues' of the period should be matched with the cost [expenses] of the period. The term 'matching' means appropriate association of released revenues and expenses. In other words, income made by the business during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. The question when the payment was received or made is 'irrelevant'. On account of this concept, adjustments are made for all outstanding expenses, accrued incomes, prepared expenses and unearned incomes etc. while preparing the final accounts at the end of the accounting period.

1.2.2 CONCEPTS TO BE OBSERVED AT THE REPORTING STAGE

Following are the concepts under this category:

1. **Accounting Period Concept:** According to this concept, the life of the business is divided into appropriate segments for studying the results shown by the business after each segment. This is because though the life of the business is considered to be indefinite [according to goingoncern concept], the measurement of income and studying the financial position of the business after a very long period would not be helpful in taking proper corrective steps at the appropriate time. It is, therefore, absolutely necessary so that after each segment or time interval the businessman must 'stop' and 'see back', how things are going. In accounting such a segment or time interval is called 'accounting period'. It is usually of a year.

   At the end of each accounting period an Income Statement and a Balance Sheet are prepared. The Income Statement discloses the profit or loss made by the business during the accounting period while the Balance Sheet depicts the financial position of the business as on the last day of the accounting period. While preparing these statements a proper distinction has to be made between capital and revenue expenditure.

2. **Conservatism concept**: In the initial stages of accounting, certain anticipated profits which were recorded, did not materialise. This resulted in less acceptability of accounting figures by the end- users. On account of this reason, the accountants follow the rule 'anticipate no profit but

provide for all possible losses' while recording business transactions. In other words, the accountant follows the policy of 'playing safe'. On account of this convention, the inventory is valued 'at cost or market price whichever is less'. Similarly a provision is made for possible bad and doubtful debts out of current year's profits. This concept affects principally the category of current assets. The convention of conservatism has become target of serious criticism these days especially on the ground that it goes against the convention of full disclosure. It encourages the accountant to create secret reserves [e.g. by creating excess provision for bad and doubtful debts, depreciation etc.] and the financial statements do not depict a true and fair view of state of affairs of the business. The Income Statement shows a lower net income, the Balance Sheet understates assets and overstates liabilities.

The research studies conducted by the American Institute of Certified Public Accountants have indicated that conservatism concept needs to be applied with much more caution and care if the results reported are not to be distorted.

3. **Materiality Concept**: According to this convention the accountant should attach importance to material details and ignore insignificant details. This is because otherwise accounting will be unnecessarily overburdened with minute details. The question what constitutes a material detail, is left to the discretion of the accountant. Moreover, an item may be material for one purpose while immaterial for another. For example, while sending each debtor 'a statement of his account', complete details up have to be given. However, when a statement of outstanding debtors is prepared for sending to top management, figures may be rounded off to the nearest ten or hundred. The Companies Act also permits ignoring of 'paise' while preparing financial statements. Similarly for tax purposes, the income has to be rounded off to nearest ten.

   Thus, the term 'materiality' is a subjective term. The accountant should regard an item as material if there is reason to believe that knowledge of it would influence the decision of the informed investor. According to Kohler, "materiality means the characteristic attaching to a statement, fact or item whereby its disclosure or method of giving it expression would be likely to influence the judgement of a reasonable person."

4. **Concept of consistency:** According to this convention accounting practices should remain unchanged from one period to another. For example, if stock is valued at 'cost or market price whichever is less', this principle should be followed year after year. Similarly if depreciation is charged on fixed assets according to diminishing balance method, it should be done year after year. This is necessary for the purpose of comparison. However, consistency does not mean inflexibility. It does not forbid introduction of improved accounting techniques. However, if adoption of such a technique results in inflating or deflating the figures of profit as compared to the previous period, a note to that effect should be given in the financial statements.

5. **Concept of full disclosure**: According to this convention accounting reports should disclose fully and fairly the information they purport to represent. They should be honestly prepared and sufficiently disclose information which is of material interest to proprietors, present and potential creditors and investors. The convention is gaining more importance because most of big businesses are run by joint stock companies where ownership is divorced from management. The Companies Act 2013, not only requires that Income Statement and Balance Sheet of a company must give a true and fair view of the state of affairs of the company, but it also gives the prescribed forms in which these statements are to be prepared. The practice of appending notes to the accounting statements [such as about contingent liabilities or market value of investments] is in pursuant to the convention of full disclosure.

1.3 SYSTEMS OF BOOK-KEEPING

Book-keeping is the art of recording in the books of account the monetary aspect of commercial and financial transactions. Book-keeping is recording of the financial transaction of a business in a systematic manner so that information on any point may be quickly obtained. Book-keeping and accounting are different terms. Book –keeping is the art of keeping or maintaining accounts in a prescribed manner. Accounting is concerned with design of the system of records, preparation of reports based on recorded data and the interpretation of reports. The recording of transactions may be done according to any of the following two systems:

1.3.1 DOUBLE ENTRY SYSTEM

Double entry book keeping is the orderly recording of financial transactions of a business in a systematic manner. The system of 'double entry' book-keeping, which is believed to have originated with the Venecian merchants of the fifteenth century, is the only system of recording the two- fold aspect of the transaction-(i.) An aspect of giving and (ii.) An aspect of receiving . For every business transaction, there are two contracting parties. For each transaction involves exchange of equal values or benefits. In each transaction, there is someone to receive and someone to give the benefit of equal value. One who receives is a debtor and one who gives is a creditor. Under the double entry system, both these aspects receiving and giving– are recorded in terms of account. Under this system, the total amount of the debit entries and that of credit entries on the various accounts must be equal.

Advantages of Double Entry System:

1 A complete and reliable record of all business transactions is provided

2 As both debit and credit aspects of a transaction are recorded, a trial balance can be prepared and arithmetical accuracy can be easily verified

3 The Profit and Loss account can be prepared to find out the profit or loss earned or suffered during a given period.

4. The balance sheet of the business can be prepared to ascertain the financial position on a particular date
5. The Double Entry System enables businessmen to ascertain purchases, sales, expenditure, income, assets, liabilities of the current year as well as those of previous year to make simple comparison which helps management to take appropriate decisions.

1.3.2 SINGLE ENTRY SYSTEM

It is 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. It does not record the two fold effect of each and every transaction. Generally, a cash book and personal accounts are only maintained. This system has been developed by some business houses, which for their convenience keep only some essential records. The accounts are maintained, under this system, in a defective and unsystematic manner and thus are not reliable and can be used only by small firms.

Distinction between Double Entry System and Single Entry System:

1. Under Double Entry System both the aspect i.e. debit and credit, of all the transactions are recorded. Under Single Entry System, there is no record of some transactions, and some transactions are recorded only in one of their aspects.

2. 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.

3. Under Double Entry System, there is a ledger which contains personal, real and nominal account. But Under Single Entry System the ledger contains some personal accounts only.

4. Under Double Entry System preparation of trial balance is possible, but it is not possible in Single Entry System, hence accuracy of work is uncertain.

5. Under Double Entry System, Trading account, Profit & Loss account and balance sheet are prepared in a scientific manner but it is not possible under Single Entry System.

Rules of Debit and Credit:

Every business enterprise deals with persons, firms or companies. Any business process contains properties, such as goods, cash, buildings and furniture to carry on the business. It may also incur certain expenses and receive income from various sources. All these classes are common to every business enterprise. In order to have a complete record of all these transactions, it must maintain accounts for all these transactions. Accounts can be mainly classified into two : personal and impersonal accounts. Impersonal accounts are again classified into real and nominal accounts. The rules of debit and credit are different for all these account

Personal Account includes the accounts of person with whom the business deals. The rule of debit and credit for personal account is

Debit the Receiver;
Credit the Giver

For recording each transaction the account which receives the benefit should be debited and the account which gives the benefit should be credited. For example, if Ravi receives cash from Suraj then Ravi's account will have to be debited and Suraj's account has to be credited.

Real Account: The rule of debit and credit for real account is

Debit what comes in;
Credit what goes out

For example, if a Motor Vehicle has been purchased for cash, then the Motor vehicle's account should be debited and cash account should be credited.

Nominal Account: The rule of debit and credit for nominal accounts is

Debit all Expenses and losses;
Credit all Incomes and Gains

Example: State the nature of account [nominal, real, or personal] and show which account will be debited and which account will be credited

i. *Rent paid*

ii. *Rent received*

iii. *Interest received*

iv. *Building purchased*

v. *Machinery sold*

vi. *Goods purchased*

vii. *Discount allowed*

viii. *Capital introduced*

ix. *Goods sold*

Solution :

Account	***Nature of account***	***Debited /credited***
Rent paid account	*Nominal*	*Debited*
Rent received account	*Nominal*	*Credited*
Interest received account	*Nominal*	*Credited*
Building account	*Real*	*Debited*
Machinery account	*Real*	*Credited*
Goods account [purchases account]	*Real*	*Debited*
Discount allowed account	*Nominal*	*Debited*
Capital account	*Personal*	*Credited*
Goods account [sales account]	*Real*	*Credited*

1.4 SUMMARY

Accounting is the process of identifying, measuring and communicating economic information in a systematic manner and it provides the information to various users. In order to satisfy the needs of different people interested in the accounting information, different branches of accounting have developed i.) Financial Accounting- which involves providing information to the external users; ii.) Management accounting- which provide information to the managers to carry out their responsibilities and functions such as planning, control, execution and decision-making; and iii.) Cost Accounting which provides data under different elements, for different functions of the management.

Accounting concepts provide the conceptual guidelines for application in the financial accounting process. Different accounting concepts are Business Entity Concept, Going Concern Concept, Money Measurement Concept, Cost Concept, Dual Aspect Concept, Accounting Period Concept, Matching Concept, and Realization Concept.

Book-keeping is a part of accounting which deals with recording transactions and keeping records. The Double Entry System is that system which recognises and records both the aspects of transactions. For every business transaction there are two contracting parties. For each transaction involves exchange of equal values or benefits. In each transaction, there is someone to receive and someone to give the benefit of equal value.

1.5 REFERENCES

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SELF ASSESMENT QUESTIONS

1. Define Accounting. State its objectives and scope.
2. State the person who should be interested in accounting information.
3. Explain the role of accountant in the present day economy.
4. Discuss briefly the basic accounting concepts and conventions.
5. According to the principle of Double Entry System every debit has corresponding credit- Explain clearly. Discuss the merits of double entry system.
6. Explain the classification of accounts. State the rule of debit and credit in these different categories of accounts.

UNIT-02 THE ACCOUNTING PROCESS

Objectives:

After going through this unit, you must be able to understand:

- How to pass appropriate Journal Entries for recording transaction in the Journal.
- The role of Ledger in recording business transactions.
- The meaning and rules regarding posting.
- The distinction between Journal and Ledger.
- The meaning and object of preparing a Trial Balance.
- How to prepare a Trial Balance.

Structure :

2.1 JOURNAL

The first step in book- keeping is the recording of transaction. A journal is *a book of original entry* wherein transactions are first recorded. The word 'journal' was originally derived from the French word *jour* which means 'day'. It is also known as the day book because it records daily transactions in the order in which they take place. The journal is the chronological record [i.e. in order of date] of the transactions of a business, showing date for each amounts and accounts to be debited and credited and an explanation. All business transactions can be recorded in a simple journal. An enterprise may use several journals in which to record special phases of its activities, e.g. for purchases on credit, it may use Purchases journal; for sales on credit, it may use Sales journal; for purchases returns, Purchases Returns journal and so on. These journals are called Special journals.

When two or more transactions of the same nature take place on the same date, a compound or combined journal entry may be passed for them instead of passing separate entry for each transaction. Thus total number of book-keeping entries may be reduced. These entries are called **compound journal entries**.

Journal Format

The format of a journal is given below:

Date	**Particulars**	**L.F.**	**Dr. Amount** ₹	**Cr. Amount** ₹

Date: The date on which the transaction was entered is recorded here

Particulars: The details of the two aspects of transaction, the debit and the credit are recorded in this column

L.F. : It means ledger folio, the transactions entered in the journal are later on posted in the ledger.

Debit: In this column, the amount to be debited is entered.

Credit: In this column, the amount to be credited is shown.

2.1.1 TRANSACTIONS RELATING TO GOODS

The term goods include articles purchased by the business for resale. Goods purchased by the business may be returned back to the supplier. Similarly, goods sold by the business to its customers can also be returned by the customers back to the business due to certain reasons. In business, it is desired that a separate record be kept of all sale, purchase and return of goods. Hence, goods accounts can be classified into the following categories:

i. Purchases Account: The account is meant for recording all purchases of goods. Goods come in on purchasing of goods and, therefore, the Purchase Account is debited on purchase of goods and cash account [or personal account] is credited.

ii. Sales Account: The account is meant for recording of selling of goods. The goods go out on selling of goods and, therefore, on sale of goods, the sales account is credited and cash account [or personal account] is debited.

iii. Purchases return Account: The account is meant for recording return of goods purchased. The goods go out on returning of goods to the suppliers and, therefore, the account should be credited on returning goods purchased and cash account [or personal account] is debited.

iv. Sales Return Account: The account is meant for recording return of goods sold by the customer. The goods come in and, therefore, the Sales Return Account should be debited on return of goods and cash account [or personal account] is credited

2.1.2 TRANSACTIONS RELATING TO BAD DEBTS

Bad debts means that money which we could not collect from our debtors. We may give the goods or money on credit to our debtors. Same debtor or debtors have to give us the money of debt they have taken. But when the debt is not collected despite efforts it is loss for the business, so, we have to pass the entry for bad debts like the entry of any other business loss. All losses account will be debited and any asset which will decrease will be credited. In case of bad debt following journal entry will be passed.

1. Journal Entry for Bad Debt Loss

For showing this journal entry, it is very necessary that a debt must be uncollectible. We have done all the efforts but we could not collect the debt. After failure of final notice to the debtor, we will convert our debt into bad debt.

Bad Debt Account Debit

Particular Debtor Account Credit

Example: *Shyam did not pay us our Rs. 5000 debt and Ram did not pay us our Rs. 10000 debt upto the end of the financial year. This receivable amount has converted into bad debt loss by following entry.*

Bad Debts Account Debit 15000

Shyam Account Credit 5000

Ram Account Credit 10000

2. Journal Entry for Bad Debts Written Off

Written off means, we are closing bad debt account by transferring bad debt amount to the debit side of our profit and loss account . When we will show bad debts in the debit side of profit and loss account, bad debts account will show same amount in its credit side. So, both side of bad debt account will be equal. No balance will be carried forward.

Profit and Loss Account Debit

Bad Debts Account Credit

Example : *Shyam did not pay us our Rs. 5000 debt and Ram did not pay us our Rs. 10000 debt upto the end of the financial year. This receivable amount has converted into bad debt loss and then written off by transferring it to profit and loss account*

Profit and Loss Account Debit 15000

Bad Debts Account Credit 15000

3. Journal Entry for Bad Debts Recovered:

When bad debts are recovered from debtor after the closing of our financial year, we will show it as our income. Like other incomes, bad debts recovered will also be our income. So, this account will be credited. We will debit that asset account which will increase. By earning this income, our bank account will increase because we received the money from our debtor. At that time, the following entry will be passed.

Bank Account Debit

Bad Debts Recovered Account Credit

Example : *Shyam did not pay us our Rs. 5000 debt and Ram did not pay us our Rs. 10000 debt upto end of the financial year 2011. In the financial year 2012, we received Rs. 6000 from Ram and 2000 from Shyam on 7th June 2012*

Bank Account Debit 8000

Bad Debt Recovered Account Credit 8000

Example : *Enter the following transactions in the Journal of Mr. Raj*

		Rs.
July 2015, 1	*Raj commenced his business with a capital of*	*1,00,000*
1	*Bought machinery*	*30,000*
2	*Bought goods for cash from Ram*	*5,000*
2	*Sold goods for cash to Ramesh*	*4,000*
3	*Purchased goods from Jailal on credit*	*2,200*
4	*Cash sales to Hari*	*12,000*
5	*Credit sales to Harish*	*3,400*
5	*Bought goods from Kamal on credit*	*1,920*
8	*Bought office furniture for cash from Modern Furnishers*	*5,000*
12	*Paid advertisement expenses to Anil & Co.*	*1,200*
20	*Received interest from Mohan*	*500*
21	*Deposited cash into bank*	*2,000*
23	*Paid rent to Harish*	*1,500*
27	*Paid salary to Narendra*	*3,500*

Journal in the Books of Raj

Date	Particulars	L.F.	Debit [Rs.]	Credit [Rs.]
2015 July 1	Cash A/c Dr. To Raj's Capital A/c [Being business started]		1,00,000	1,00,000
July 1	Machinery A/c Dr. To Cash A/c [Being purchase of machinery for cash]		30,000	30,000
July 2	Purchase A/c Dr. To Cash A/c [Being purchase of goods for cash]		5,000	5,000
July 2	Cash A/c Dr. To Sales A/c [Being goods sold for cash]		4,000	4,000
July 3	Purchase A/c Dr. To Jailal A/c [Being purchase of goods on credit from Jailal]		2,200	2,200
July 4	Cash A/c Dr. To Sales A/c [Being sales of goods for cash to Hari]		12,000	12,000
July 5	Harish A/c Dr. To Sales A/c [Being sale of goods on credit to Harish]		3,400	3,400
July 5	Purchase A/c Dr. To Kamal A/c [Being purchases of goods on credit from Kamal]		1,920	1,920

July 8	*Furniture A/c Dr.* *To Cash A/c* *[Being purchase of furniture on cash from Modern Furnishers]*		*5,000*	*5,000*
July 12	*Advertisement expenses A/c Dr.* *To Cash A/c* *[Being payment of advertisement expenses]*		*1,200*	*1,200*
July 20	*Cash A/c Dr.* *To Interest A/c* *[Being interest received from Mohan]*		*500*	*500*
July 21	*Bank A/c Dr.* *To Cash A/c* *[Being cash deposited in-to bank]*		*2,000*	*2,000*
July 23	*Rent A/c Dr.* *To Cash A/c* *[Being rent paid to Harish]*		*1,500*	*1,500*
July 27	*Salary A/c Dr.* *To Cash A/c* *[Being salary paid in cash]*		*3,500*	*3,500*

2.2 LEDGER

After enteringtransactions in the Journal chronologically, these entries must be transferred to appropriate accounts in the Ledger periodically i.e.weekly, monthly or quarterly, depending on the convenience and requirement of the business. This is done to know the exact position of each account on any particular date.

The term Ledger has been derived from the Dutch word *legger*, which means to lie. Ledger, therefore, means a book in which various accounts lie. A ledger is a collection or set of accounts. It is a book where transactions of similar nature are grouped together in one place in the form of an account. It contains the accounts of persons with whom the business deals, assets or things possessed by the business, as well as expenses incurred and income gained by the business.

Format of Ledger Account:

Ledger has two sides: debit side and credit side. The left side of an account is known as debit side, and is for writing debit entries. The right hand side is known as credit side, and is meant for writing credit entries. At the top left corner, the word 'Dr' [Debtor] and at the top right corner the word 'Cr' [Creditor] should be written.

Dr. **Cr.**

Date	**Particulars**	**J.F.**	**Amount** [Rs. Ps.]	**Date**	**Particulars**	**J.F.**	**Amount** [Rs.]
	Debit side				Credit side		

2.2.1 POSTING INTO LEDGER

The process of transferring the entries recorded in the Journal into appropriate accounts in the Ledger is called posting. A journal entryconsists of two parts: debit and credit. The debit aspect goes to debit side of an account in the Ledger and the credit aspect goes to credit side of another account in the Ledger. For example, when cash is received from Mohan, cash account is debited and Mohan's account is credited in the Journal. In the Ledger, an entry is made on the debit side of cash account and a corresponding entry on the credit side of Mohan's account. Thus posting is the process of recording the debit and credit aspects, by reference to Journal, to various Ledger accounts. Steps involved in posting are as under:

1. Take the debit aspect of a Journal entry.
2. Look into the account opened to be debited in the Ledger.
3. Enter the date in the Date column.
4. In the Particulars column, write the name of the other aspect appearing in the second line of the Journal entry with a prefix 'To'.
5. The page number of the Journal may be entered in the J.F. column and that of the Ledger account may, in turn, be entered in the L.F. column of the Journal.
6. The debit amount in the Amount column.
7. Then take the credit aspect of the same Journal entry.
8. Post it to the credit of that account opened for crediting it with prefix 'By'. Then the other aspect should be written in the Particulars column.
9. The page number in the appropriate column and the credit amount in the Amount column.

Difference between Journal and Ledger:

1. A Journal is book of first or prime entry as all transactions are recorded first in it. But a Ledger is a book of final entry, as the transactions are recorded finally in a Ledger.

2. Journal is a subsidiary book because it does not provide information for the preparation of final accounts. It merely helps the preparation of Ledger accounts. But Ledger is the principal book of accounts because it provides the final accounting information relating to the business.

3. Journal is a daily record as all the transactions are entered in it daily. But posting from the Journal to the Ledger is done periodically, say, weekly, monthly, quarterly according to the convenience and requirement of the business.

4. In Journal, the information relating to a particular item may not be found in one place. But in Ledger, it is found in one place.

5. The unit of entries in the Journal is a transaction, whereas that in the Ledger is an account.

6. Recording transaction in Journal is called journalising, but that in the Ledger is called posting.

7. Narration is written in the Journal. But no narration is required in the case of Ledger.

2.2.2 BALANCING LEDGER ACCOUNTS

At the end of each month or year, or on any particular day, it may be necessary to ascertain the balance in an account. There may be numerous debits and credits in an account. The difference between the two sides of an account is known as **account balance** . If the debit side is heavier than the credit side, it shows a debit balance, and if the credit side is heavier than the debit side, it means credit balance. The process of ascertaining the balance of a particular account on a given date is known as **balancing the account** or **striking the balance**. In order to balance an account, we should total up the two sides roughly on a separate piece of paper. The total of the side which is heavier is put on both sides leaving a little space just above the total for carrying down [c/d] the balance at the lower side. Again the difference in the account i.e., balance in that account, should be brought down [b/d] on the heavier side. These closing balances will be the opening balances for the next period. In case the total of both the sides of an account are equal, then that account is said to have no balance at all.

2.2.3 SIGNIFICANCE OF BALANCES

Personal account:

A personal account may show a debit balance or a credit balance. Debit balance indicates that the person concerned has received more benefits from the business than what he has given to the business. Therefore, the person owes some amount to the business and is a debtor. If a person's account shows a credit balance, then it indicates that the person concerned has given more benefits to the business than what he has taken from it. The business, therefore, owes some amount to him and he is its creditor. If personal account is showing debit balance, it is unfavourable to him. If it shows credit balance, it is favourable to the person concerned.

Real account:

Real accounts are accounts relating to assets, properties or possessions and will always show debit balance. These are possessed or acquired by the businessmen, and are called assets and with a debit balance. As against this, all liabilities will show credit balance.

Nominal account

The nominal accounts are accounts relating to expenses, losses, incomes and gains. These are not balanced along with other accounts. But, at the end of the accounting period, the debits or credits of these accounts are transferred to Trading and Profit and Loss accounts. By doing so, these Nominal accounts will be closed. It may be stated that Expenses accounts will show debit balance and incomes accounts will show credit balance. Purchases, sales, purchases return, sales return accounts are also not balanced, rather closed by transfer to Trading and Profit and Loss accounts. Opening stock account is not balanced but closed by transfer to trading account. Closing stock account is balanced and it is brought into books only on the last day of the accounting period to be carried down.

Example: Post the following transaction in the ledgers of Ram:

April 2015,

1	*Sold goods for cash Rs. 2,600*
2	*Bought goods for cash Rs. 200*
3	*Bought goods from Kumar Rs. 3,000*
4	*Sold goods on credit to Mani Rs. 4,000*
5	*Received cash from Mani Rs. 2,500*
6	*Paid to Kumar in full settlement of his account Rs. 2,900*
7	*Bought furniture for cash Rs. 10,000*

Solution :

Dr. **Cash A/c** Cr.

Date	Particulars	Amount [Rs.]			Date	Particulars	Amount [Rs.]
2015					2012		
April 1	To sales	2,600			April 2	By Purchase	200
April 5	To Mani	2,500			April 6	By Kumar	2,900
April 30	To Bal. c/d	8,000			April 7	By Furniture	10,000
		13,100					13,100
						By Bal. b/d	8,000

Dr. Sales A/c Cr.

Date	Particulars	Amount [Rs.]	Date	Particulars	Amount [Rs.]
2015			2015		
April 3	To Bal. c/d	6,600	April 1	By Cash	2,600
			April 3	By Mani	4,000
		6,600	May 1		6,600
				By Bal. b/d	6,600

Dr. **Purchase A/c** Cr.

Date	Particulars	Amount [Rs.]	Date	Particulars	Amount [Rs.]
2015			2015		
April 2	To Cash	200	April 30	By Bal. c/d	3,200
April 3	To Kumar	3,000			
May 1		3,200			3,200
	To Bal. b/d	3,200			

Dr. ***Kumar's A/c*** *Cr.*

Date		*Particulars*	*Amount [Rs.]*	*Date*	*Particulars*	*Amount [Rs.]*
2015				*2015*		
April 6		*To Cash*	*2,900*	*April 3*	*By Purchase*	*3,000*
April 6		*To Discount*	*100*			
			3,000			*3,000*

Dr. ***Mani A/c*** *Cr.*

Date	*Particulars*	*Amount [Rs.]*	*Date*	*Particulars*	*Amount [Rs.]*
2015			*2015*		
April 4	*To sales*	*4,000*	*April 5*	*By Cash*	*2,500*
			April 30	*By Bal. c/d*	*1,500*
		4,000			*4,000*
May 1	*To Bal. b/d*	*1,500*			

Dr. ***Furniture A/c*** *Cr.*

Date	*Particulars*	*Amount [Rs.]*	*Date*	*Particulars*	*Amount [Rs.]*
2015			*2015*		
April 7	*To Cash*	*10,000*	*April 30*	*By Bal. c/d*	*10,000*
		10,000			*10,000*
May 1	*To Bal. b/d*	*10,000*			

2.2.4 TRIAL BALANCE

Trial balance is a simple listing of all accounts with the debit balances posted into the Debit column and the credit balances posted into the Credit column. Although it looks like an account, because it has a debit and a credit column, it is not an account but merely a list of account balances. Simply put, it ensures that for every debit amount there are equal credit amounts.

If we take the accounts showing debit balances to one side and the accounts showing credit balances to the other side , the two sides should be equal. If the total of debit balances does not agree with that of credit balances, it is evident that there are some mistakes which should be found out and rectified. To test the arithmetical accuracy of books of accounts these balances are taken to a statement which is called a Trial Balance.

M.S. Gosav defines Trial Balance as "A statement containing the balance of all ledger accounts, at any given date, arranged in the form of debit and credit columns placed side by side, and prepared with the object of checking the arithmetical accuracy of the ledger posting"

Main Characteristics and Uses of a Trial Balance

1 It is a statement prepared in a tabular form. It has two columns one for debit balances and other for credit balances.

2 Closing balances, i.e. balances at the end of the period as shown by ledger accounts, are shown in the statement.

3 Trial balance is not an account. It is only a statement of balances.

4 It can be prepared on any date provided accounts are balanced.

5 It is a consolidated list of all ledger balances at the end of a period at one place.

6 It is a method of verifying the arithmetical accuracy of entries made in the ledger. The agreement of the trial balance means that the total of the debit column agrees with the total of the credit column of the trial balance.

7 It is a big help in preparing of Trading account , Profit and Loss Account and the Balance Sheet at the end of the period which exhibit the financial position of the firm.

Methods of preparing Trial Balance:

A trial balance may be prepared according to any of the two methods:

i. Total Method or Gross Method: In this method, the total of debit and credit of the accounts are shown in the trial balance. Trial balance is prepared before ledger accounts are balanced. The total of the debit and credit columns of the trial balance must be equal.

ii. Balance Method or Net Method: In case of this method, the balances of the ledger accounts are shown in the respective debit and credit columns of the trial balance. The total of the balance of the debit column must be equal to the total balance of the credit column.

Format of a Trial balance

The total of all debits and credits of all ledger accounts is shown in the Trial Balance Debit and Credit columns.

Trail Balane of ....Co Ltd.

As on ....

S.No	Name of Account	L.F.	Debit [Rs.]	Credit [Rs.]
1	Capital			***
2	Drawings		***	
3	Purchases		***	
4	Sales			***
5	Purchase Return			***
6	Sales Return		***	
7	Carriage Inwards		***	
8	Carriage Outwards		***	
9	Duty on purchases		***	
10	Opening stock		***	
11	Motor van		***	
12	Furniture		***	
13	Fittings		***	
14	Buildings		***	
15	Land		***	
16	Goodwill		***	
17	Patent		***	
18	Sundry debtors		***	
19	Sundry creditors			***
20	Cash in hand		***	
21	Cash at bank		***	
22	Discount Allowed		***	
23	Discount Received			***
24	Rent		***	
25	Salary		***	

26	Interest received			***
27	Bills payable			***
28	Bills receivable		***	
29	Reserve			***
30	Provision			***
31	Loan from bank			***
32	Loan to XYZ		***	
33	Bank overdraft			***
34	General expenses		***	

Limitations of Trial Balance:

1. Omission of an entry in the original book: if an entry has not been recorded in the original or subsidiary book at all, then both the aspects of the transaction will be omitted and the trial balance will not be affected.
2. Posting an item on the correct side but to the wrong account, then trial balance will agree but it will not reveal the error.
3. The error of wrong amount entered in the subsidiary book will not be revealed by trial balance.
4. If the Trial balance is not accurate, the final accounts prepared on the basis of this may not exhibit a true and fair view of the state of business affairs.

Example : Journalise the following transaction and post them to ledger. Also prepare trial balance:

2015

March	*1*	*Shyam commenced business with Rs. 2,00,000 in cash*
	3	*He buys merchandise of Rs. 1,50,000 on account from Dhamesh*
	5	*He buys furniture for Rs. 30,000 on account from Narain*
	8	*He pays Narain Rs. 29,000*
	10	*He pays Dhamesh Rs. 30,000*
	15	*Cash sales Rs. 50,000*
	18	*He sells goods to Rajesh on credit Rs. 7,000*
	31	*Salary paid in cash Rs. 5,000*
	31	*Rent paid to landlord Rs. 4,000*

Journal

Books of Shyam

Date	*Particulars*	*L.F.*	*Debit [Rs.]*	*Credit [Rs.]*
2015 March1	*Cash A/c Dr.* *To Shyam's capital A/c* *[Being business started]*		*2,00,000*	*2,00,000*
March 3	*Purchase A/c Dr.* *To Dhamesh A/c* *[Being purchase of goods on credit]*		*1,50,000*	*1,50,000*
March 5	*Furniture A/c Dr.* *To Narain A/c* *[Being purchase of furniture on credit]*		*30,000*	*30,000*
March 8	*Narain A/c Dr.* *To Cash A/c* *[Being payment made to Narain against purchase of furniture]*		*29,000*	*29,000*
March 10	*Dhamesh A/c Dr.* *To Cash A/c* *[Being payment made to Dhamesh against purchase of goods]*		*30,000*	*30,000*

March 15	*Cash A/c Dr.* *To Sales A/c* *[Being sales of goods for cash]*		*50,000*	*50,000*
March 18	*Rajesh A/c Dr.* *To Sales A/c* *[Being sale of goods on credit to Rajesh]*		*7,000*	*7,000*
March 31	*Salary A/c Dr.* *Rent A/c Dr.* *To Cash A/c* *[Being salary and rent paid in cash]*		*5,000* *4,000*	*9,000*

Ledgers accounts

Dr. ***Cash A/c*** *Cr.*

Date	*Particulars*	*Amount [Rs.]*	*Date*	*Particulars*	*Amount [Rs.]*
2015			*2015*		
March1	*To Shyam's Capital*	*2,00,000*	*March 8*	*By Narain*	*29,000*
March15	*To Sales*	*50,000*	*March10*	*By Dhamesh*	*30,000*
			March31	*By Salary*	*5,000*
				By Rent	*4,000*
			March31	*By Bal. c/d*	*1,82,000*
		2,50,000			*2,50,000*
April 1	*To Bal. b/d*	*1,82,000*			

Dr. **Shyams's Capital A/c** Cr.

Date	Particulars	Amount [Rs.]	Date	Particulars	Amount [Rs.]
2015	To Bal. c/d	2,00,000	2015		
March 31			March 1	By cash	2,00,000
			April 1	By Bal. b/d	2,00,000

Dr. **Purchase A/c** Cr.

Date	Particulars	Amount [Rs.]	Date	Particulars	Amount [Rs.]
2015			2015	By Bal. c/d	1,50,000
March 3	To Dhamesh	1,50,000	March31		
April 1	To Bal. b/d	1,50,000			

Dr. **Furniture A/c** Cr.

Date	Particulars	Amount [Rs.]	Date	Particulars	Amount [Rs.]
2015			2015	By Bal. c/d	30,000
March5	To Narain	30,000			
April 1	To Bal. b/d	30,000	March31		

Dr. **Narain A/c** Cr.

Date	Particulars	Amount [Rs.]	Date	Particulars	Amount [Rs.]
2011			2015		
March 8	To Cash	29,000	March 5	By Furniture	30,000
March 31	To Bal. c/d	1,000			

		30,000	April 1		30,000
				By Bal. b/d	

Dr. ***Dhamesh A/c*** *Cr.*

Date	*Particulars*	*Amount [Rs.]*	*Date*	*Particulars*	*Amount [Rs.]*
2015			*2015*		
March10	*To Cash*	*30,000*	*March 3*	*By purchase*	*1,50,000*
March 31	*To Bal. c/d*	*1,20,000*			
		1,50,000	*April 1*		*1,50,000*
				By Bal. b/d	

Dr. ***Rajech A/c*** *Cr.*

Date	*Particulars*	*Amount [Rs.]*	*Date*	*Particulars*	*Amount [Rs.]*
2015			*2015*	*By Bal. c/d*	*7,000*
March 18	*To Sales*	*7,000*			
	To Bal. b/d	*7,000*	*March31*		
April 1					

Dr. ***Sales A/c*** *Cr.*

Date	*Particulars*	*Amount [Rs.]*	*Date*	*Particulars*	*Amount [Rs.]*
2015	*To Bal. c/d*	*57,000*	*2015*		
March 31		*57,000*	*March 15*	*By Cash*	*50,000*
				By Rajesh	*7,000*
			March 18	*By Bal. b/d*	*57,000*
			April 1		

Dr. **Salary A/c** Cr.

Date	*Particulars*	*Amount [Rs.]*	*Date*	*Particulars*	*Amount [Rs.]*
2015 *March 31* *April 1*	 *To Cash* *To Bal. b/d*	 *5,000* *5,000*	*2015* *March31*	*By Bal. c/d*	*5,000*

Dr. **Rent A/c** Cr.

Date	*Particulars*	*Amount [Rs.]*	*Date*	*Particulars*	*Amount [Rs.]*
2015 *March 31* *April 1*	 *To Cash* *To Bal. b/d*	 *4,000* *4,000*	*2015* *March31*	*By Bal. c/d*	*4,000*

Trial Balance as on March 31, 2015 [Total Method]

Shyam's Book

S.No.	***Name of Account***	***L.F.***	***Debit [Rs.]***	***Credit [Rs.]***
1	*Cash Account*		*2,50,000*	*68,000*
2	*Shyam's Capital Account*		-	*2,00,000*
3	*Purchases Account*		*1,50,000*	-
4	*Furniture Account*		*30,000*	-
5	*Narain Account*		*29,000*	*30,000*
6	*Dhamesh Account*		*30,000*	*1,50,000*
7	*Rajesh Account*		*7,000*	-
8	*Sales Account*		-	*57,000*
9	*Salary Account*		*5,000*	-
10	*Rent Account*		*4,000*	-
	Total		*5,05,000*	*5,05,000*

Trial Balance as on March 31, 2015 [Balances Method]

Shyam's Book

S.No.	***Name of Account***	***L.F.***	***Debit [Rs.]***	***Credit [Rs.]***
1	*Cash Account*		*1,82,000*	
2	*Sham's Capital Account*		-	*2,00,000*
3	*Purchases Account*		*1,50,000*	-
4	*Furniture Account*		*30,000*	-
5	*Narain Account*		-	*1,000*
6	*Dhamesh Account*		-	*1,20,000*
7	*Rajesh Account*		*7,000*	
8	*Sales Account*		-	*57,000*
9	*Salary Account*		*5,000*	-
10	*Rent Account*		*4,000*	-
	Total		*3,78,000*	*3,78,000*

2.2.5 OPENING ENTRY

In case of a running business, the assets and liabilities appearing in the previous year's balance sheet will have to be brought forward to the current year. This is done by means of a journal entry which is termed as 'opening entry'. All Asset accounts are debited while all Liability accounts are credited. The excess of assets over liabilities is the proprietor's capital and is credited to his capital account. This will be clear with the help of following example:

Example : Pass the Opening entry on January 1, 2015 on the basis of the following information

		Rs.
i	*Cash in hand*	*2,000*
ii	*Sundry debtors*	*6,000*
iii	*Stock of goods*	*4,000*
iv	*Plant*	*5,000*
v	*Land and buildings*	*10,000*
vi	*Sundry creditors*	*10,000*

Date	Name of Account	L.F.	Debit [Rs.]	Credit [Rs.]
2015 Jan 1	Cash A/c Dr. Sundry debtors A/c Dr. Stock A/c Dr. Plant A/c Dr. Land & Building A/c Dr. To Sundry Creditors To Capital A/c [balancing figure] [Being balances brought forward from the last year]		2,000 6,000 4,000 5,000 10,000 27,000	 10,000 17,000 27,000

2.3 SUMMARY

Financial transactions are generally recorded in the Journal. The transaction recorded in the Journal will be in the form of journal entries. The process of recording transaction in a Journal is termed as journalising.

Ledger is a book where transactions of similar nature are grouped together in one place in the form of an account. It contains the accounts of persons with whom the business deals, the assets or things possessed by the business, as well as the expenses incurred and the income gained by the business. The terms 'debit' and 'credit' are used to describe the left-hand and the right-hand side of an account.

Trial balance is a list of accounts and their balances at a given time and is used to verify the equality of debits and credits in the ledger. When the total of debit balance equals the total of credit balance, the ledger is said to be in balance. Since the Trial Balance is abstract of all the ledger balance, with its help, the final accounts and the Balance Sheet can be easily prepared.

2.4 REFERENCES

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2. Kuppapally Jelsy Joseph, Accounting for Managers, PHI Learning Pvt Limited, New Delhi, 2008
3. Maheshwari, S.N & Maheshwari S.K, An Introduction to Accountancy, Vikas Publishing House, New Delhi, 2005

4. Sahaf, M.A., Management Accountinng: Principles and Practice, Vikas Publishing House, New Delhi, 2009

SELF ASSESMENT QUESTIONS

1. Explain the meaning of term Journal and state its significance.
2. Explain the different rules for journalizing the transaction with appropriate illustrations.
3. Explain the rules regarding posting of transaction into the ledger.
4. What is a trial balance? Explain its objectives.
5. Journalise the following transaction and post them into the ledger:

Jan, 2016		Rs.
1	Surendra started business with cash	5,000
2	Goods purchased from Prasad on credit	200
3	Goods sold to Prem	500
4	Goods purchased from Sohan for cash	400
5	Paid for wages	50
15	Goods purchased from Prem	100
17	Goods sold to Om	50
21	Goods purchased from Charanjit	300
23	Paid for interest	15
24	Goods purchased from Om	200
28	Cash received from Prem	100
31	Cash paid to Charanjit	300
31	Paid for rent	10

UNIT-03 CASH BOOK AND RECONCILIATION

Objectives :

After going through this unit, you must be able to understand:

- The meaning and importance of cash book;
- Why main journal is split into a number of separate journals;
- The accounting process relating to preparation of different types of cash book with the help of illustrations;
- Why a Reconciliation statement is prepared;
- Causes of difference between cash book balance or overdraft, and bank pass book balance or overdraft;
- The special journals, their form, nature, recording and posting procedure; and
- The imprest system of keeping petty cash

Structure :

3.1 Sub-division of Journal

3.2 Cash Book

3.2.1 Single Column Cash Book

3.2.2 Two Column Cash Book

3.2.3 Three Column Cash Book

3.3 Bank reconciliation statement

3.3.1 Causes of difference

3.3.2 Preparation of Bank Reconciliation Statement

3.3.3 When is there an overdraft?

3.3.4 Adjusting the Cash Book balance

3.3.5 Advantages of Bank Reconciliation Statement

3.4 Petty Cash Book

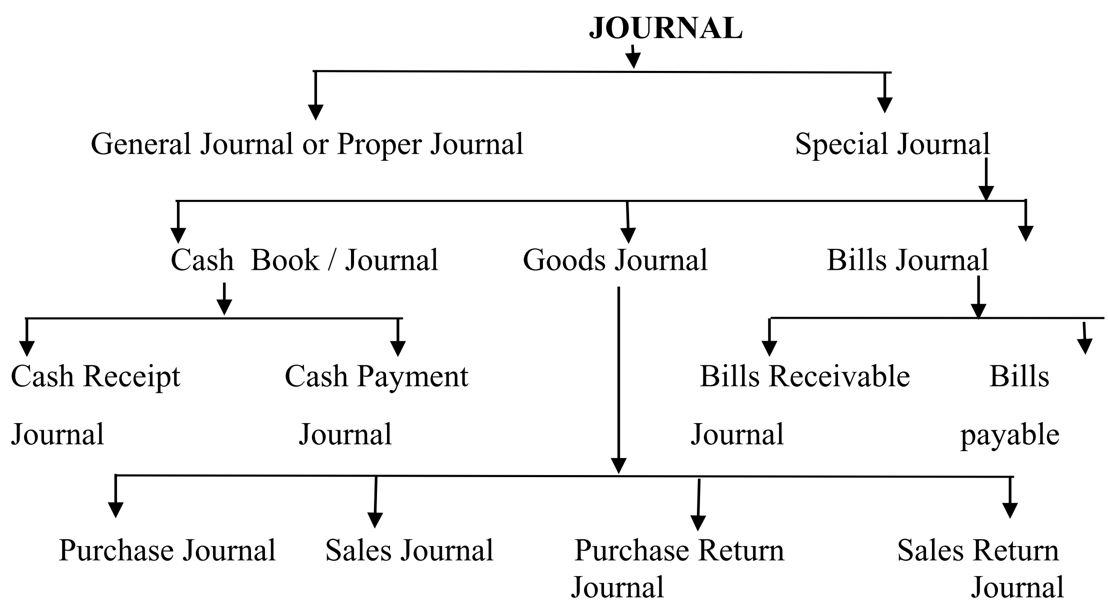
3.4.1 Imprest system

3.4.2 Recording and posting the Petty Cash Book

3.1 SUB-DIVISION OF JOURNAL

In a big business recording of all transaction in one journal will not only be inconvenient but also cause delay in collecting required information. The journal is, therefore, sub-divided into many subsidiary books.

The subdivision of journal can be explained with the help of following chart:



3.2 CASH BOOK

Cash book may be defined as the record of transactions concerning cash receipts and cash payments. It is common experience in any business that transactions affecting cash occur very frequently. Cash sales, cash purchases, payment of expenses like salaries, wages, cartage, carriage, commission, rent, electricity expenses, water bills, rates and taxes, collection of cash from customers, payments to creditors are a few examples of transactions affecting cash. In view of the above fact the necessity of a separate book for recording cash transactions cannot be over-emphasised.

The function of a cash book is to record all cash receipts and payments of an enterprise from day to day. All cash received is recorded on the left-hand side or the debit side of the cash book while all cash payments are recorded on the right-hand side or the credit side of the cash book, the difference between the two totals indicates the balance of cash on hand.

Records of cash transactions normally are the largest in the business. If every transaction of cash were recorded in the journal, an enormous amount of unnecessary labour would be involved in debiting or crediting cash account every time cash is received or paid. It is by this device of passing cash transactions through the cash book that the labour of posting every item of receipts or payment of cash individually to cash account in the ledger is avoided.

Cash book fulfils the functions of a book of Original Entry as also a ledger account. it is not necessary to have a separate cash account in the ledger because the record in the cash book takes the shape of a ledger account. In a cash book, only cash transactions are recorded in the order in which they occur. Thus, it serves the purpose of a subsidiary book and ledger account. By giving the cash book the shape of an account, the fundamental rule, that every entry must first be recorded in the book of prime entry and then posted to ledger, has been discarded.

Cash book can be of the following types:

i. Single column cash book

ii. Two column cash book

iii. Three column cash book

3.2.1 SINGLE COLUMN CASH BOOK

In the single cash column, there is only one column, i.e. cash column. It is just like a cash account. The specimen is as under:

Dr. **CASH BOOK** **Cr.**

Date	Particulars	L.F.	Amount [Rs.]	Date	Particulars	L.F.	Amount [Rs.]

Cash book is divided into two parts- the left –hand side is used for recording cash receipts and the right –hand side is used for recording cash payments.

Example : *Enter the following transactions in the single column cash book of Mr. Venkat.*

2015 *Rs.*

September	*1*	*Started business with cash*	*20,000*
	2	*Purchased furniture*	*3,000*
	3	*Purchased electrical equipment*	*1,000*
	6	*Purchased goods on cash from Mr. Vohra*	*4,500*
	8	*Cash sales*	*500*
	10	*Paid for goods*	*2,000*
	11	*Cash sales to Mr.Jai*	*280*
	13	*Paid interest to Mr. Rao*	*100*
	15	*Paid cartage*	*25*
	20	*Cash sales*	*500*
	21	*Paid salaries*	*5,000*
	28	*Paid rent*	*3,000*
	30	*Paid miscellaneous expenses*	*300*

Dr. ***CASH BOOK*** ***Cr.***

Date 2015	***Particulars***	***L.F.***	***Amount [₹]***	***Date 2015***	***Particulars***	***L.F.***	***Amount [₹ Ps.]***
Sep				*Sep*			
1	*To Capital A/c*		*20,000*	*2*	*By Furniture*		*3,000*
8	*To Sales*		*500*	*3*	*By Electrical Equipment*		*1,000*
11	*To Sales*		*280*	*6*	*By Purchases*		*4,500*
20	*To Sales*		*500*	*10*	*By Purchases*		*2,000*
				13	*By Interest*		*100*
				15	*By Cartage*		*25*
				21	*By Salaries*		*5,000*
				28	*By Rent*		*3,000*
				30	*By Misc. Expenses*		*300*
				30	*By Balance c/d*		*2,355*
			21,280				*21,280*
Oct1	*To Balance b/d*		*2,355*				

Note: The debit side of Cash book is heavier than the credit side in the sense that cash receipts during a period should be more than cash payments during that period. It is called a debit balance. In the above example, cash book has a debit balance of Rs. 2,355.

3.2.2 TWO COLUMN CASH BOOK

In this cash book, two columns are kept on both sides. One is for cash and second is for discount. This cash book is also called as cash book with cash and discount columns. On the left hand side of the cash book, cash discount allowed to customers is shown in the discount column while on the right–hand side, cash discount received from suppliers or creditors is shown in discount column.

The specimen of such a two columnar cash book is given below

Dr. **CASH BOOK WITH CASH AND DISCOUNT COLUMNS** **Cr.**

Date	**Particulars**		**L. F.**	**Discount [₹]**	**Cash [₹]**	**Date**	**Particulars**	**L. F.**	**Discount [₹]**	**Cash [₹.]**

Cash discount allowed: Sales of goods on credit is a common phenomenon in the business. When goods are sold on credit, the customers enjoy the facility of making the payment on some date in the future. In order to encourage them to make the payment before the expiry of the credit period a deduction is offered. The deduction so made is known as cash discount. A separate column is provided for the cash discount allowed in the cash book. When the amount is received from a customer who has availed of cash discount, the actual amount is put in the discount column. Cash discount allowed is in the nature of expense and is thus debited.

Cash discount received: Whenever payment to a creditor is made before the expiry of credit period, certain discount is allowed by him. In such a case actual payment made is put in the cash column and discount earned is put in the discount column. Cash discount received on payment of amount is in the nature of revenue. The amount of cash discount received is credited to discount account and debited to party's account to whom the payment is made.

Example: Enter the following items in the two-column cash book, post them to ledger accounts.

1 *Jan 1,2015* *Cash balance Rs. 5000*

2 *Jan 6* *Sold goods to Mahesh Rs. 4000*

3 *Jan 8* *Purchased goods from Mukesh Rs. 3000*

4 *Jan 15* *Cash received from Mahesh Rs. 3,900 in full satisfaction*

5 *Jan 20* *Paid to Mukesh Rs. 2,850 in full satisfaction*

6 *Jan 25* *Sold goods to Suresh Rs. 3,000*

7 *Jan 31* *Received cash from Suresh Rs. 2,900 in full satisfaction.*

Dr. **CASH BOOK WITH CASH AND DISCOUNT COLUMNSCr.**

Date	**Particulars**	**L.F.**	**Discount [Rs.]**	**Cash [Rs.]**
Jan 1, 2015	*To balance b/d*			*5,000*
Jan 5	*To Mahesh*		*100*	*3,900*
Jan 31	*To Suresh*		*100*	*2,900*
			200	*11,800*
Jan 20, 2015	*By Mukesh*		*150*	*2,850*
Jan 31	*By Balance c/d*			*8,950*
			150	*11,800*

Ledger

Mahesh

Date	**Particulars**	**Amount [₹]**	**Date**	**Particulars**	**Amount [₹]**
Jan 6	*To sales A/c*	*4,000*	*Jan 15*	*By Cash*	*3,900*
			Jan 15	*By Discount*	*100*
		4,000			*4,000*

Suresh

Date	**Particulars**	**Amount [₹.]**	**Date**	**Particulars**	**Amount [₹]**
Jan 25	*To sales A/c*	*3,000*	*Jan 31*	*By Cash*	*2,900*
			Jan 31	*By Discount*	*100*
		3,000			*3,000*

Mukesh

Date	Particulars	Amount [₹]	Date	Particulars	Amount [₹]
Jan 20 Jan 20	To Cash A/c To Discount A/c	2,850 150 3,000	Jan 8	By Purchase A/c	3,000 3,000

Discount Allowed Account

Date	Particulars	Amount [₹]	Date	Particulars	Amount [₹.]
Jan 31 Jan 31	To Sundries To Balance b/d	200 -------- 200	Jan 31	To Balance c/d	200

Discount Received Account

Date	Particulars	Amount [₹]	Date	Particulars	Amount [₹]
Jan 31	To Balance c/d	150 150	Jan 31 Jan 31	To Sundries To Balance b/d	150 150

3.2.3 THREE COLUMN CASH BOOK

It is a very popular form of cash book. Where a business enterprise has a current account in a bank, it would pay therein most of its cash receipts and cheques received from various customers and others and would then make most of the payment by cheques drawn on such bank account. Under such a situation, a more elaborate cash book would have to be designed so as to serve the combined purpose of a cash account and a bank account, without in any way disturbing the double entry principles. The ruling would, in this situation consist of discount, cash and bank columns on both sides of the cash book. The three columns provided are as follows:

i the first column is for discount, which is a nominal account

ii the second column is for cash, which is a real account and

iii the third column is for bank, which is a personal account

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

CASH BOOK

Date	Receipts	L.F.	Dis. N	Cash R	Bank P	Date	Payments	L.F.	Dis. N	Cash R	Bank P

N- Nominal account R – Real account P- Personal account

In three-column cash book, bank column is provided on both sides. All deposits into bank are written on the debit side while all withdrawals from bank are written on the credit side. The difference between the two sides reflects the balance at bank. Thus this bank column serves the functions of a bank account in the ledger. Thus, the three-column cash book contains cash, bank, and discount column on both sides- debit and credit.

One important feature of this cash book is that if a transaction involves both the cash and bank account. it is entered on both the sides of the cash book, one in the cash column and second in the bank column, though on opposite sides. This is called a 'Contra' entry and the word C is put in the ledger folio column on both sides of the cash bank.

Balancing the Three-column Cash book: The firm will balance cash and bank columns separately. Cash account will always show a debit balance. The bank account generally shows a debit balance, but in some cases it may have a credit balance i.e. the payments from bank are more than the bank receipts. This is the case of an overdraft. The bank charges interest on overdraft. The discount columns on debit and credit sides of the cash book are not balanced. They are simply totalled. Discount account is maintained in the ledger.

Cheques received: when a firm receives a cheque from a party, it is generally deposited in the bank on the same day. It is entered in the bank column on the debit side of the cash book. Sometimes, this cheque is not deposited in the bank on the same day. Rather, it is deposited in the bank afterwards. In such cases, the cheque is kept in cash box and is entered in the cash book in the cash column on the debit side. When it is deposited in the bank after this date, a contra entry is made- first on the credit side in the cash column and then again on the debit side in the bank column.

When a cheque received from a party is endorsed in favour of a creditor of the business, the cheque received is first entered in the cash column on the debit side in the name of the party who had given this cheque. Then, it will be entered on the credit side in the cash column in the name of the party to whom it has been endorsed.

Example:

Feb 1,2015 Opening balance Cash Rs. 3,000

Bank Rs. 4,000

Feb 4 Rent paid by cheque Rs. 2,000

Feb 6 Received on account of cash sales Rs. 3,000

Feb 8 Paid to Mehta Bros. By cheque Rs. 2,000 and earned Rs. 200 as cash discount

Feb 10 Received from Suresh by cheque Rs. 2,000 and allowed him Rs.100 as cash discount

Feb 12 Cash sales Rs. 20,000

Feb 20 Cash purchases Rs. 15,000

Feb 28 Salaries paid Rs. 5,000

CASH BOOK

Date	***Receipts***	***L. F.***	***Dis. ₹***	***Cash ₹***	***Bank ₹***	***Date***	***Payments***	***L. F.***	***Dis. ₹***	***Cash ₹***	***Bank ₹***
Feb, 2015						Feb, 2015					
1	To Bal. b/d			3,000	4,000	6	By Rent A/c				2,000
6	To Sales A/c			3,000		8	By Mehta Bros		200		2,000
10	To Suresh		100		2,000	20	By Purchase A/c			15,000	
12	To Sales A/c			20,000		28	By Salary A/c			5,000	
						28	By Bal. c/d			6,000	2,000
			100	26,000	6,000				200	2,600	6,000
	To bal. b/d			6,000	2,000						

Example : Enter the following transactions in the appropriate type of the cash books.

2015

July 1 Started business with an investment of Rs. 9,000

July 2 *Deposited in Bank of India Rs. 7,000*
July 4 *Acquired a building by issuing a cheque of Rs. 5,000*
July10 *Paid the bill of the furniture by cheque Rs.1,000*
July 15 *Purchased Rs. 800 of merchandise by cheque*
July 18 *Withdrew Rs.100 from the bank*
July 20 *Sold merchandise for Rs. 1,200*
July 22 *Deposited Rs. 2,000 into the bank*
July 25 *Bought Rs. 1,000 merchandise*
July 26 *Sold Rs. 1,500 merchandise by crossed cheque*
July 27 *Paid Rs. 100 by cheque as the premium for insuring building against fire*
July 28 *Paid freight Rs. 50*
July 30 *Withdrew from bank for personal use Rs. 500*
July 31 *Cleared electricity bill Rs. 90*
July 31 *Paid to Mahesh Rs. 1,080 in full satisfaction by cheque. We owed to Mahesh Rs. 1,100 for goods purchased*
July 31 *Received from Suresh a cheque for Rs. 1,480, in full satisfaction of the debit of Rs. 1,510*

CASH BOOK

Date	***Receipts***	***L.F.***	***Dis. ₹***	***Cash ₹***	***Bank ₹***	***Date***	***Payments***	***L.F.***	***Dis. ₹***	***Cash ₹***	***Bank ₹***
July,						July,					
2015						2015				7,000	
1	To			9,000		2	By Bank	C			5,000
2	Capital	C			7,000	4	By				1,000
18	To Cash	C		100		10	Building				800
20	To			1,200		15	By				100
22	Bank	C			2,000	18	Furniture	C		2,000	
26	To				1,500	22	By	C		1,000	
31	Sales		30		1,480	25	Purchase				100
	To Cash					27	By Cash				
	To						By Bank			50	
	Sales					28	By				500
	To					30	Purchase			90	
	Suresh					31	By				
						31	Insurance				
						31	Premium				
							By				
							Freight				
							By				
							Drawings				
							By				
							Electricity		20		1,080
			30	10,300	11,980		By			160	3,400
				160	3,400		Mahesh		20	10,300	11,980
	To Bal.						By Bal.				
	b/d						c/d				

3.3 BANK RECONCILIATION STATEMENT

In order to avoid the risk attached with the keeping of money in the office, it is a general practice in the business that the amount received is deposited in the bank; and similarly, to check misappropriation and fraud in the disbursement of money all the payments [excepting petty cash payments] are made by cheque. When money is deposited by the firms into the bank, the firm debits the bank account since bank account is a personal account and, as per accounting rule, the bank being the receiver has to be debited. Similarly, when money is withdrawn from the bank, the firm gives credit to the bank account since bank is the giver. On the other hand on receipt of money from the customer [the firm], the bank gives credit to the customer since the customer's account is a personal account, and he is the giver. Similarly on money being withdrawn by the customer, the bank debits the account of the customer since he is the receiver. thus the balance as shown by the firm's book in the bank account should tally with the balance shown by the bank's book in the account of the firm. If the bank's account in the books of the firm shows a debit balance, the firm's account in the books of the firm shows a credit balance; and vice- versa.

All transactions relating to the bank- deposits or withdrawals- are recorded by the firm in the bank column maintained on each side of the cash book. The deposit of money into the bank account is recorded on the debit side of the cash book in the bank column, while the withdrawal of money is recorded on the credit side in the bank column of the cash book. The bank also maintain the firm's account in its books. A copy of this account is submitted to the firm from time to time. The account submitted by the bank to the customer is known as the bank pass book or bank statement. A pass book or the Bank Statement is submitted by the bank to the customer for his information and verification. A **Bank reconciliation** is a process that explains the difference between the bank balance shown in an organization's bank statement, as supplied by the bank, and the corresponding amount shown in the organization's own accounting records at a particular point in time.

3.3.1 CAUSES OF DIFFERENCE

The following are the causes of difference between the balance as shown by the bank pass book and the balance as shown by the firm's cash book:

i **Cheques issued but not presented for payment:** The firm issues cheques from time to time for making different payments. As soon as a cheque is issued, the firm debits the party's account in whose favour the cheque is issued and credits the bank's account. However, the bank comes to know of issue of such cheques only when they are presented for payment. The bank, therefore, debits the firm's account only when the cheque is actually presented for payment. It may, therefore, be possible that on a particular date when the bank is submitting the firm's statement of account, it may not include certain cheques which have been issued by the firm because they may not have yet been presented. Thus the balance shown by the bank's book in the firm's account will be higher than the balance shown by the firm's books in the bank account.

ii **Cheques sent for collection but not yet collected:** A firm receives, from time, to time cheques from its customers which is sent to its bankers for collection and for crediting the proceeds to its account. The firm debits the account of the bank as soon as it sends the cheques to the bank for collection. However, the bank gives credit to the firm only when the cheques are actually collected. Thus, on a particular date it may be possible that certain cheques which were sent for collection by the firm to the bank may not have been collected by the bank and, therefore, not credited to the firm's account. The two balances- the balance as shown by the bank pass book and the firm's cash book- will, therefore, be different.

iii **Bank charges:** The Bank charges its customers for the services it renders to them from time to time. The bank may charge its customer for remitting funds at his instruction from one place to another. It may also charge for collecting outstation cheques or bills of exchange of its customer. The bank debits the customer's account as soon as it renders such a service. However, a customer will know of such charges only when he receives a statement of account from the bank. Thus, on a particular date, the balance shown by the bank pass book may be different from the balance shown by the cash book.

iv **Direct collection on behalf of customer:** A banker may receive amounts due to the customer directly from customer's debtors. The bank gives credit to the customer for such collection as soon as it gets such payments. However, the customer comes to know of such collection only when he receives the statement of account from his banker. Thus, the balance shown by the bank pass book and the firm's cash book may not be the same on account of this reason.

v **Errors**: There may be errors in the account maintained by the customer as well as the bank. A wrong credit or debit may be given by the customer or the bank. The two balances, therefore, may not tally.

3.3.2 PREPARATION OF BANK RECONCILIATION STATEMENT

A Bank Reconciliation statement is prepared usually at the end of a period as may be convenient and necessary by the firm, taking into account the number of transactions involved. The following are the steps to be taken for preparing a Bank Reconciliation Statement:

1 The cash book should be completed and the balance as per the bank column on a particular date should be arrived at for the period for which the Bank Reconciliation Statement has to prepared.

2 The bank should be requested to complete and send to the firm the bank pass book upto the date on which the Reconciliation Statement is to be prepared.

3 The balance as shown by either the cash book or the bank pass book should be taken as the base. This, as a matter of fact, is the starting point for determining the balance as shown by the other book after making suitable adjustments taking into account the causes of difference.

4 The effect of that particular cause of difference should be studied on the balance shown by the other book.

5 In case, the cause has resulted in an increase in the balance shown by the other book, the amount of such an increase should be added to the balance shown in the former book which has been taken as the base.

6 In case, the cause has resulted in a decrease in the balance shown by the other book, the amount of such a decrease should be deducted from the balance shown in the former book which has been taken as the base.

Example: Prepare Bank Reconciliation Statement as on 31st , Dec. 2015 from the following information:

i Debit balance as per Cash book Rs. 2,000

ii Cheques issued but not presented Rs. 150

iii Cheques deposited but not collected by Bank Rs. 100

iv Interest charged by Bank Rs. 20

Bank Reconciliation Statement

as on 31st Dec. 2015

Particulars	*Amount [Rs.]*
i Debit balance as per Cash Book Rs. 2,000	*2,000*
ii Add Cheques issued but not presented Rs. 150	*150*
	2,150
iii Less Cheques deposited but not collected by Bank Rs. 100	*100*
	2,050
iv Less Interest charged by Bank Rs. 20	*20*
Credit balance as per Pass Book	*2,030*

3.3.3 WHEN THERE IS AN OVERDRAFT

Overdraft in pass book occurs when the business firm has withdrawn excess money from the bank under the overdraft arrangement with the bank. Overdraft in the bank pass book implies a debit balance. It will be termed as a credit balance in the cash book. The bank usually charges interest on overdrawn balance from the customer. If the overdraft as shown by the pass book is taken as the starting point, cheques issued but not presented for payment will be added to overdraft. Similarly cheques deposited but not credited in the pass book will be deducted from the given overdraft to arrive at the overdraft figure as per cash book.

3.3.4 ADJUSTING THE CASH BOOK BALANCE

It may be easy to reconcile the difference by looking at very recent transactions in either the bank statement or the organisation's own accounting records (Cash Book) and seeing if some combination of them tallies with the difference to be explained. Otherwise it may be necessary to go through and match every single transaction in both sets of records since the last reconciliation, and see what transactions remain unmatched. The necessary adjustments should then be made in the Cash Book, or any timing differences recorded to assist with future reconciliations.

3.3.4 ADVANTAGES OF BANK RECONCILIATION STATEMENT

Bank Reconciliation Statement highlights the causes of difference between the bank balance as per Cash Book and the bank balance as per Pass Book. Necessary adjustment or correction can, therefore, be carried out at the earliest.

It reduces the chances of fraud by the staff handling cash. It may be possible that the cashier may not deposit the money in the bank in time though he might have passed the entry in the bank column of the cash book. The Bank Reconciliation Statement will project such discrepancies.

There is a moral check on the staff of the organization to keep the cash records always up-to–date. To minimise the amount of work involved, it is a good practice to carry out such reconciliations at reasonably frequent intervals. Reconciliations are generally performed by specialised accounting software though the understanding of what occurs is important for a successful reconciliation.

3.4 PETTY CASH BOOK

In every business, of whatever size, there are many payments which are of small amounts and high frequency. Examples are: payments for stationery, postage, telegrams, carriage, cleaning, travelling, Petty Cash Book is maintained by the business to record these petty cash expenses of the business. If all these payments are recorded in the Cash Book, it will unnecessarily be overburdened. In order to make the task of the cashier easy, a *petty cashier* is appointed and is handed over a small sum which is found sufficient enough to meet the requirements of a given period. This small amount is called '*imprest*' or '*float*'. The petty cashier makes the payments of petty expenses for which he is authorised and records them in his cash book called '*Petty Cash Book*'. All these payments are supported by vouchers or receipts. At the end of the given period, the petty cashier submits the accounts to the cashier, who after having examined the accounts, makes the payment of the amount spent by the petty cashier. Thus again on the first day of the next month, the petty cashier is found with the same cash balance which he had on the first day of the previous month.

3.4.1 IMPREST SYSTEM

Imprest system of maintaining petty cash is the most scientific method. The essential feature of this system is that the total petty cash expenditure for a period [say a month] is estimated at the beginning of the month and then a round sum is given to the petty cashier for making petty payments during the month. At the end of the month, the petty cashier submits the statement of expenditure made along with supporting vouchers in the form of petty cash book to the main cashier, who after verifying the payments, makes good the total amount actually incurred, so that the petty cashier will have the same figure of cash at the beginning of the next month as he had at the beginning of the previous month.

Advantages:

i The main cashier is relieved of maintaining record of petty payments. He can look after the important aspects of cash management in a better way.

ii Small payments are not stuffed in the main cash book. They are shown separately in petty cash book.

iii Complete and reliable check is maintained on small items of expenses. Proper control can be exercised on such payments.

3.4.2 RECORDING AND POSTING THE PETTY CASH BOOK

Posting in the ledger from the petty cash book is done at the end of the period. There are two alternative ways of making posting from the petty cash book:

1. Petty Cash Book maintained as a Memorandum Book only: In such a case the total of the various expenses from the petty cash book is debited, to the concerned accounts at the end of the period and credit is given to the Cash account with the actual expenditure incurred. The amount advanced by the Chief cashier to the petty cashier is recorded by him as a memorandum by way of a note in the cash book itself.

2. Where petty cash book is taken as a part of the double entry system. This method is quite popular. The recording is done regarding the petty cash transactions on the basis of the following entries:

   a. When money is advanced to the petty cashier

   Petty cash Account   Dr.

   To cash Account

[The petty cash account is debited with the actual amount of money advanced]

b. On submission of accounts by the petty cashier

Expenses Accounts Dr.

To Petty cash Account

[Each expense is to be debited separately with the expenditure incurred during the period as shown by the petty cash book]

Thus in the ledger, there is a 'petty cash account' as well as separate Expenses Accounts for each of the expenses.

Example: Enter the following transactions in the Petty Cash Book [maintained on imprest system] for the month of May, 2015

May	*1*	*Cash received from the chief cashier*	*Rs. 200*
	3	*Typing paper*	*Rs. 8*
	3	*Postage*	*Rs. 4*
	6	*Office cleaning*	*Rs. 4*
	8	*Postage*	*Rs. 2*
	8	*Office Cleaning*	*Rs. 2*
	10	*Cartage*	*Rs. 2*
	15	*Postage*	*Rs. 6*
	18	*Ink*	*Rs. 3*
	18	*Typing paper*	*Rs. 10*
	20	*Typewriter ribbon*	*Rs. 10*
	22	*Telephone charges*	*Rs. 7*
	24	*Office cleaning*	*Rs. 2*
	25	*Polish*	*Rs. 27*
	27	*Telegrams*	*Rs. 25*
	29	*Typing paper*	*Rs. 30*

PETTY CASH BOOK

Receipts												
Date	***Particulars***	***Cash book folio***	***Total***	***Date***	***Particulars***	***Voucher nos***	***Stationary Rs***	***Postal Charges Rs***	***Cartage Rs***	***Cleaning***	***Mis. Exp. Rs.***	***Total Rs.***
12 4 4 2 6 13 10 7 2 27 25 30 14 2 58 20 0	To cash from chief cashier To Bal b/d To cash from chief cashier	14 2	20 0 20 0 58	May, 20 15 3 6 8 10 15 18 20 22 24 25 27 29	Typ.paper, postge Office cleaning Post, off. cleaning Cartage Postage Ink, typ. Paper Type. Ribbon Tele. Charges Cleaning Exp. Polish Telegrams Typ. Paper Ledger folio Balance c/d	1,2 3 4, 5 6 7 8,9 10 11 12 13 14 15	8 13 10 30 61 2	4 2 6 7 25 44 3	2 2 4	4 2 2 8 5	27 27 6	

The various ledger accounts [according to the second method] will appear as follows:

Dr. **Petty Cash Book** *Cr.*

Date	Particulars	Amount ₹		Date	Particulars	Amount ₹
Jul 1	To Cash	200		Jul 3	By Stationery	61
					By Postal charges	44
					By Cartage	2
					By Cleaning Exp.	27
					By Miscellaneous Exp.	27
					By Balance c/d	58
		200				200
Aug 1	By balance b/d	58				

Stationery Account

Date	Particulars	Amount		Date	Particulars	Amount
Jul 31	To Petty cash A/c	61				

Postal Charges Account

Date	Particulars	Amount		Date	Particulars	Amount
Jul 31	To Petty cash A/c	71				

Cartage Account

Date	*Particulars*	*Amount*	*Date*	*Particulars*	*Amount*
Jul 31	*To Petty cash A/c*	*2*			

Cleaning Exp. Account

Date	*Particulars*	*Amount*	*Date*	*Particulars*	*Amount*
Jul 31	*To Petty cash A/c*	*8*			

Miscellaneous Exp. Account

Date	*Particulars*	*Amount*	*Date*	*Particulars*	*Amount*
Jul 31	*To Petty cash A/c*	*27*			

3.5 SPECIAL PURPOSE SUBSIDIARY BOOKS

The system of book- keeping should be easy, simple to follow and should be such as can allow division and sub- division of duties and speedy working. It the size of the business is a small one, then it is possible to enter each and every transaction in the journal. But when size of the business grows it is no longer possible to record all the transaction in one general journal, but the main journal is split into a number of separate journals or Day Books. A separate Day book is used for each type of transaction. For instance, separate day books are kept in big-sized business for receipts and payments of cash, credit purchases and sales of goods, return of goods purchased and sold, bills receivable and bills payable. These journals are prepared almost every day and are of specialized character as they include transactions relating to one type of transaction. They are, therefore, known as special journals or special purpose subsidiary books. Subsidiary books may be defined as books where transactions are enteredfirst for the purpose of record. These journals may be enumerated as under:

3.5.1 PURCHASE JOURNAL

The purchase journal is meant for recording credit purchases of goods. It is also known as the Purchases or Bought Day Book. It has columns for date of purchase, invoice number, name of the party, ledger folio and the amount of purchases. The book records only purchase of good on credit. Purchases of items other than goods on credit are recorded in the General Journal. Similarly, cash purchases are recorded in the cash book.

Posting: The posting is done in the Personal Accounts daily from the Purchases Book at the end of a week /month, the total of the Purchases Book is debited to the Purchases Account in the ledger.

Format

Purchases Journal

Date	**Inward invoice no.**	**Name of Supplier**	**L.F.**	**Amount [Rs.]**

Example: Record the following transactions in the Purchase Journal and post them in the ledger

2015

Jan 1 Purchased from Ram & Co. On credit

38 Immersion Heaters@ Rs. 100

20 Philips Tubelights @ Rs. 200

Jan 4 Purchased from Shyam & Co. On credit

40 Immersion Heaters@ Rs. 100

20 E.C.E. Tubelights @ Rs. 150

Jan 8 Purchased from Bajaj & Co. On credit

20 Electric Irons @ Rs. 400

3 Electric Mixers @ Rs. 1000

Jan 24 Purchased from K.C. & Co. On credit

30 Electric Kettles @ Rs. 200

40 Table fans @ Rs. 2000

PURCHASES JOURNAL

Date	***Invoice No.***	***Particulars***	***L.F.***	***Amount [Rs.]***	***Amount [Rs]***
2015					
Jan 1	*50*	*Ram & Co.:*	*4*		
		38 Immersion Heaters@ Rs. 100		*3000*	
		20 Philips Tubelights @ Rs. 200		*4000*	*7000*
Jan 4	*55*	*Shyam & Co. On credit*	*8*		
		40 Immersion Heaters@ Rs.100		*4000*	
		20 E.C.E. Tubelights @ Rs.150		*3000*	*7000*
Jan 8	*62*	*Bajaj & Co. On credit*	*12*		
		20 Electric Irons @ Rs. 400		*8000*	
		3 Electric Mixers @ Rs. 1000		*3000*	*11,000*
Jan 24	*65*	*K.C. & Co. On credit*	*13*		
		30 Electric Kettles @ Rs. 200		*6000*	
		40 Table fans @ Rs. 2000		*80,000*	*86,000*
Jan 31		*Purchases Account Dr.*	*14*		*1,11,000*

Ledger

Ram & Co. *[folio 4]*

Date	*Particulars*	*Amount*		*Date*	*Particulars*	*Amount*
				Jan 1	*By Purchases*	*7000*

Shyam & Co. . *[folio 8]*

Date	*Particulars*	*Amount*		*Date*	*Particulars*	*Amount*
				Jan 4	*By Purchases*	*7000*

Bajaj & Co. . *[folio 12]*

Date	*Particulars*	*Amount*		*Date*	*Particulars*	*Amount*
				Jan 8	*By Purchases*	*11000*

K.C. & Co. . *[folio13]*

Date	*Particulars*	*Amount*		*Date*	*Particulars*	*Amount*
				Jan 24	*By Purchases*	*86,000*

Purchases Account. *[folio 14]*

Date	*Particulars*	*Amount*		*Date*	*Particulars*	*Amount*
Jan 31	*To Sundries*	*1,11,000*				

3.5.2 SALES JOURNAL

Sales journal is used for recording sales of goods on credit. If there are cash sales, they are recorded in the cash book and not in sales journal. If some asset, instead of goods, is sold on credit, it is recorded in general journal. The use of sales journal is very much limited to the recording of only credit sales of goods. The term 'goods' is used to describe those things which are purchased by the business for the purpose of resale.

Posting: The transactions relating to credit sale of goods after having been recorded in the sales journal are posted to accounts kept in ledger. Sales of goods to individuals is normally posted daily. The persons involved are debited with the necessary amount. Total sales of the period is credited to sales account.

Format

Sales Journal

Date	Outward invoice no.	Name of customer	L.F.	Amount [Rs.]

3.5.3 PURCHASES RETURN JOURNAL

The book is meant for recording return of goods purchased on credit. The goods purchased for cash and returned are not recorded in this book. they are recorded in a memorandum book only. On receipts of cash in respect of the goods returned, the entry will be passed through cash book. In case, the goods are exchanged for other goods of the same value, no entry will be required. The entry in the memorandum book will be cancelled on getting cash or goods for goods returned. The entries in the personal accounts are done daily from the Purchases Return book. they are debited with the respective amounts. The total of the 'purchase return book' is posted to the credit of purchases return account at the end of the period.

Debit note: When the goods are returned to the supplier, a debit note is sent to him indicating that this account has been debited with the amount mentioned in the debit note.

Format:

Purchases Return Journal

Date	Debit note no.	Name of Supplier	L.F.	Amount [Rs.]

3.5.4 SALES RETURN JOURNAL

The Sales Return Journal is meant for recording return of goods sold on credit. The goods which are sold for cash, if returned, are either exchanged for new goods or the parties are paid in respect of them depending upon the circumstances. In case the goods returned are not immediately exchanged for the other goods or not paid for in cash, they are recorded in a memorandum book only. Thus, goods sold for cash and returned do not find a place in the 'sales return journal'. They are recorded in cash book in the case cash is paid for them or no entry will be passed in case they have been recorded in a memorandum book only. The posting from the 'sales return journal' will be done daily in the personal account. The total of the sales return journal will be posted to the debit of sales return account at the end of the period.

Credit note: The customer, who returns the goods, gets credit for the value of the goods returned. A Credit Note is sent to him intimating that his account has been credited with the value of the goods returned.

Format

Sales Return Journal

Date	**Credit note no.**	**Name of customer**	**L.F.**	**Amount [Rs.]**

Example: Prepare Purchase Return Journal and Sales Return Journal from the following

Aug 1 Bhat Bros., Agra returned – credit

Note no.- 1005

5 pairs of shoes for being defective @ Rs.350 per pair

Less trade discount 10%

8 returned to Ludhiana shoe store, Ludhiana

Debit note no. 554

100 pairs of sandles being not up to the approved sample @ Rs. 150 per pair

Less trade discount 10%

16 Liberty Shoes, New Delhi, returned 10 pairs of ladies chappals

@ Rs. 200 per pair

Credit note no. 1006

Less trade discount 10%

22 Returned to Metro Shoes Pvt. Ltd. , Kanpur

Debit note no. 555

100 pairs boy's shoes @ Rs. 150 per pair

Less 15%

26 Amar Sons, Ambala, returned 10 pairs of girl's sandles

Credit note no. 1007 @ Rs. 180 per pair

Sales Return Journal

Date		Credit note no.	Name of customer	L.F.	Details [Rs.]	Amount [Rs.]
Aug 1		1005	*M/s Bhat Bros., Agra*			
			5 pairs of shoes @ Rs.350		1,750	
			per pair		175	1,575
Aug 16		1006	Less trade discount 10%			
			M/s Liberty Shoes, New Delhi,		2,000	
					200	1,800
		1007	*10 pairs of ladies chappals @ Rs. 200 per pair*			
Aug 26						1,800
			Less trade discount 10%			Rs. 5,175
			Amar Sons, Ambala,			
			10 pairs of girl's sandles @ Rs. 180 per pair			
			Total			

Sales Return Account

Date	*Particulars*	*L.F.*	*Amount*	*Date*	*Particulars*	*L.F.*	*Amount*
Aug 31	*To total as per Sales Return Book*		*5,175*				

Purchases Return Journal

Date	Debit note no.	Name of Supplier	L.F.	Details [Rs.]	Amount [Rs.]
Aug 8	554	*M/s Ludhiana Shoe Store, Ludhiana*			
		100 pairs of sandles @ Rs. 150 per pair		15,000	
		Less trade discount 10%		1,500	13,500
	555	*M/s. Metro Shoes Pvt. Ltd. , Kanpur*			
Aug 22		*100 pairs boy's shoes @ Rs. 150 per pair*		15,000	
		Less Discount 15%		2,250	12,750
		Total			26,250

Purchase Return Account

Date	*Particulars*	*L. F.*	*Amount*	*Date*	*Particulars*	*L. F.*	*Amount*
				Aug 31	*To total as per Purchase Return Book*		*26,250*

3.5.5 PROPER

Journal Proper or General Journal is used for recording such transactions as occur so infrequently that they do not warrant the setting up of special journals. Examples of such transactions are:

i **Opening entries:** The purpose of passing an opening entry is to record the opening balances of the accounts transferred from the previous year to the new year. The accounts appearing on the assets side of the balance sheet are debited in the opening entry while accounts appearing on the liabilities side are credited

ii **Adjustment entries:** The unadjusted and unrecorded items relating to the period are recorded in the journal by passing adjusting entries, e.g. entries passed for adjusting expenses paid in advance or outstanding, incomes, received in advance, incomes accrued, bad debts, depreciation, closing stock, etc. are called adjusting entries.

iii **Closing entries:** All nominal accounts relating to expenses and gains or incomes must be closed at the end of the year. In order to close them, they are transferred either to trading account or profit & loss account. Journal entry required for transferring them to trading or profit & loss account is called a 'closing entry'.

iv **Correction entries:** These are passed when errors or mistakes are discovered in accounting records. These are also called *Rectification entries*.

v **Transfer entries:** When an amount or balance of one account is to be taken to some other account, it is done by means of a transfer journal entry in the General Journal

vi **Any other entry of infrequent nature:** If, besides above, there are any other transactions which cannot be recorded in any of the special journals, they will be recorded in Journal proper.

3.6 SUMMARY

Cash book is a record of transactions concerning cash receipts and cash payments. A separate cash book is necessary because cash transaction in a business are very large in number. By having debit side on the left side and credit on the right of the cash book, a separate cash account in the ledger is not necessary. Thus, it fulfils the functions of a book of original entry as also a ledger account. A single column cash book is a cash book having only a single column i.e. cash column on both sides of the cash book. The two columnar cash book has cash and discount columns on both sides. The three-columnar cash book has three columns- cash, bank and discount on both sides of the cash book. When transactions appear on both sides in both cash and bank column at the same time they are called 'contra' entries. Under the imprest system of petty cash method the petty cashier is provided with estimated cash at the beginning of a period, for petty expenses. He meets these expenses from the imprest and at the end of the period , he is given the cash equivalent to the expenses incurred. Thus he will have the same amount of imprest amount at the beginning of the next period. This method relieves the main cashier of much botheration.

Bank Reconciliation statement is a statement prepared at periodical intervals, with a view to indicate the items which cause disagreement between the balances as per the bank columns of the cash book and the bank pass book on any given date. This statement is prepared with a view to ensure the accuracy of the two balances, and is necessarily prepared in business houses having numerous banking transaction.

Special purpose subsidiary books are kept in those business firms which have large number of transactions of different types. Separate books are kept for recording separate types of transactions. Cash transactions receipts and /or payments are recorded in cash book or journals only. Credit purchases of goods are recorded in purchase journal. Returns of goods to suppliers or creditors on account of defect in goods etc. are recorded in purchase return journal. Credit sales of goods to customers and return from them are entered in sale journal and sales return journal respectively. Journal proper is maintained for recording those transactions which do not find place in any of the special journal.

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SELF ASSESMENT QUESTIONS

1. What do you understand by special purpose subsidiary books? Give a specimen of such a book showing at least five entries.
2. Explain the imprest system of petty cash book.
3. Explain the different types of goods journal with suitable examples.
4. What is a Bank Reconciliation Statement? How is it prepared? Prepare a Proforma of a Bank Reconciliation Statement with imaginary figures .

UNIT-04 BILLS OF EXCHANGE

Objectives :

After going through this unit, you must be able to understand:

- Why Bills of Exchange and Promissory Notes are used in business.
- What is the difference between Bills of Exchange and Promissory Notes?
- The accounting aspect of Bill transactions under different circumstances.
- Why Bills Receivable Journal and Bills Payable Journal are kept and how posting from them into ledger accounts is done.
- Why are accommodation bills drawn and what is the process of their accounting treatment?

Structure :

4.1 TYPES OF INSTRUMENTS OF CREDIT

4.1.1 BILL OF EXCHANGE

A bill of exchange is a written acknowledgement of debt, given by the debtor to his creditor, for the sum due and the time of payment as well as the date and place of payment being set down.

A bill of exchange has been defined as 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'. *Example : Ram orders Shyam to pay Rs. 50,000 three months after date and Shyam accepts this order by putting his signature and name on it, then it will be a bill of exchange. The following is a specimen of a properly drawn bill of exchange.*

New Delhi

September , 2015

Rs. 50,000

Stamp

Three months after date pay to M/s Zaveri & Sons

or order the sum of Rupee Fifty Thousand only

for value received

Rameshwar Prasad

To,

M/s Dilpat & Bros.

Kamal Nagar

Delhi-110007

This is called a 'draft'. This order will be sent to M/s Dilpat & Bros. for acceptance. If it is accepted by them, they will write across the order as follows:

Accepted

For M/s Dilpat & Bros.

Dilpat Raj

Partner

After acceptance it becomes a proper bill of exchange.

Parties to a bill of exchange

There are three parties to a bill of exchange:

1 **Drawer** i.e. the person who draws the bill. He is the creditor to whom the amount is owed.

2 **Drawee** i.e. the person to whom the bill is addressed or on whom it is drawn. He is the debtor who owes the amount. After he accepts the bill, he is called 'Acceptor'.

3 **Payee** i.e the person to whom the sum of money is payable. Sometimes the drawer requires the amount to be paid to himself, in which case, the drawer and the payee are the same person.

Characteristics of a bill of exchange:

1 A bill of exchange is an unconditional order

2 It must be in writing

3 It must be dated

4 It is addressed by one person to another

5 It must contain an order to pay a fixed amount of money

6 The amount must be payable to a specified person or to his order or to the bearer of the bill

7 The draft must be accepted by the party on whom the order is drawn and addressed

Advantages of a bill of exchange:

1 An accepted bill of exchange is a written and signed acknowledgement of debt and This affords conclusive proof of indebtedness

2 Payment can be enforced on a bill of exchange in a Court of Law.

3 The date of maturity of the bill ensures the creditor when to expect his money and the debtor or acceptor also knows when he will be called upon to pay

4 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

5 The creditor need not lock up his funds because he can, if he so desires, convert it into cash by discounting the bill. Discounting means converting the bill into cash with a bank or financier after deducting a small sum known as discount from the total amount of the bill.

6 It is a negotiable instrument and can be transferred from hand to hand in settlement of debts.

7 It is easy and convenient method of transmitting money from one place to another

8 Accommodation bill enable the businessmen to obtain funds from the market at cheap rates to meet their temporary financial requirements.

4.1.2 PROMISSORY NOTE

Another method of payment similar to the bill of exchange is the Promissory note. Promissory notes are not very common in business, although they are generally used amongst private individuals in connection with loan transactions.

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 a certain person. Under Section 31[2] of the Reserve Bank of India Act, a promissory note cannot be made payable to bearer.

This also is a negotiable instrument. In fact, the term 'negotiable instrument' applies to bills of exchange, promissory note and cheques. Consideration is not an essential prerequisite of a promissory note, nor is so at the time of payment. However, it is customary to say in the note that it is being executed for value received. The note becomes payable on demand if there is no mention of the time of payment. Three days of grace, as in the case of a bill of exchange, are allowed.

Specimen of a Promissory Note

New Delhi
September , 2011

Rs. 10,000

Stamp

Three months after date we promise to pay
M/s Oriental Paper Co., Delhi or order the sum
of Rupee Ten Thousand only for value received

M/s. Thakur & Co
C. Thakur
Partner

To,
M/s Oriental Paper Co.
Chawri Bazar
Delhi-110006

Parties to a Promissory note:

There are only two parties to a Promissory note:

1 **The Maker** i.e. the person who gives the Promissory note. He is the promisor who promises to pay.

2 **The Payee** i.e the person on whose order the note is made payable

A Promissory note does not need any acceptance, as the debtor himself writes the document promising to make the payment.

Characteristics of a Promissory note

1. It must be in writing.
2. It must contain a clear promise to pay. If a debt is merely acknowledged, it is not a promise.
3. The promise to pay must be unconditional
4. It should be properly stamped
5. It should not be made payable to bearer.
6. The sum payable must be certain
7. The maker must be a specific person
8. It should be signed by the promisor or maker
9. The payee must be certain.

4.1.3 DISTINCTION BETWEEN BILL OF EXCHANGE AND PROMISSORY NOTE

The following are the mainpoints of difference between a bill of exchange and a promissory note:

1. Bill of Exchange is an unconditional order to pay but Promissory Note is an unconditional promise to pay
2. Bill of Exchange is drawn by the creditor but Promissory Note is drawn by the debtor i.e. the person who owes the money
3. There are three parties [the drawer, drawee and the payee] in the Bill of Exchange but two parties [promisor or maker and the payee]in the Promissory Note
4. Acceptance is necessary in Bill of Exchange but no acceptance is required in Promissory Note as it is drawn by the promisor, or the debtor
5. Discounting and retiring of a Bill of Exchange under rebate is allowed but discounting and retiring of a Promissory Note under rebate is not allowed
6. A Bill of Exchange can be made payable to the bearer but a Promissory Note cannot be made payable to the bearer
7. In the Bill of Exchange presentment for payment is necessary, otherwise drawee will be discharged by delay. In Promissory Note presentment for payment is not required unless it is payable after sight.

4.2 TREATMENT OF BILL BY THE HOLDER AND ITS ACCOUNTING

4.2.1 RETAINING THE BILL

This is a case when a bill is written i.e. drawing a bill and the drawee signifies his assent to the order in writing and he becomes the acceptor of the bill. From the point of view of drawer [creditor] the bill is called a bill receivable and the same bill from the point of view of of the acceptor [debtor] is called a bill payable. Journal entries in the books of a drawer and an acceptor at the time of drawing a bill are as follows

Drawer's book

Bills Receivable A/c	Dr.
To Acceptor [drawee]	

Acceptors book

Drawer	Dr.
To Bill Payable A/c	

4.2.2 DISCOUNTING THE BILL WITH THE BANK

When a bill is discounted the banker does not make the payment in cash, rather full amount of the bill is credited to party's account. Hence, in the books of the party, the bank account is debited because the amount of bill is deemed to be deposited with the banker. when bill is discounted, the following journal entries are made:

i.	Bank account	Dr.	Rs.	
	To Bill Receivable account			Rs. ....
ii.	Discount allowed	Dr.	Rs.	
	To Bank account			Rs. ....

This entry is required to record the discount charged by the banker for making the payment before the maturity date of the bill.

In some cases, instead of making two entries, only one combined entry is made:

Bank account	Dr.	Rs..........
Discount allowed	Dr.	Rs.........
To Bill Receivable account		Rs...........

Example: On 1 Feb, 2015, 'A' drew a bill on 'B' for two months for Rs. 12,000. B accepted the draft and returned it to A. A discounted the bill immediately with his *bankers at 18% per annum. Pass necessary journal entries in the books of all the parties concerned.*

Books of A

Journal Entries

Date	Particulars	L.F.	Dr. Amount[₹]	Cr. Amount [₹]
2012 Feb 1	Bill Receivable account Dr.		12,000	
	To B			12,000
	[Being the bill drawn payable after two months]			
Feb 1	Bank account Dr.		11,640	
	Discount account Dr.		360	
	To Bill Receivable account			12,000
	[Being the discounting of the bill @ 18% p.a. with the bankers viz 12000*18/100*2/12]			

Books of B

Journal Entries

Date	Particulars	L.F.	Dr. Amount[₹]	Cr. Amount [₹]
2012 Feb 1	A Dr.		12,000	
	To Bill Payable account			12,000
	[Being the bill accepted payable after two months]			
April 4	Bill Payable account Dr.		12,000	
	To Cash account			12,000
	[Being the payment of the bill at maturity]			

Books of Book

Journal Entries

Date	*Particulars*	*L.F.*	*Dr. Amount[₹.]*	*Cr. Amount [₹]*
2012 *Feb 1*	*Bill Discounted account Dr.* *To A* *To Discount on Bill Discounted A/c* *[Being bill receivable discounted@ 18% p.a payable after 2 months]*		*12,000*	 *11,360* *360*
April 4	*Cash account Dr.* *To Bill Discounted account* *[Being the bill realised on maturity]*		*12,000*	 *12,000*

4.2.3 ENDORSING THE BILL

Accounting entry to the endorsement of the bill is as follows:

Endorsee's Personal account [creditor] Dr. Rs...........

To Bill Receivable account Rs...........

This is the journal entry to be passed in the books of the endorser [or drawer]. The endorsee will pass the following entry in his books:

Bill Receivable account Dr. Rs..........

To Endorser's Personal Account Rs.......

On the due date, the endorsee will receive the payment. The endorser will not pass any journal entry because he has already debited the endorsee or creditor. The endorsee will pass the following entry in his book to record the payment:

Cash account Dr. Rs..........

To Bill Receivable account Rs.......

Example : 'A' drew on B a bill on March 1, 2015 for two months for Rs. 7,000 which B accepted and returned to A. The bill is endorsed one month after the acceptance in favour of C. On the due date, the bill was honoured. Pass necessary journal entries in the books of all the parties concerned.

Books of A

Journal Entries

Date	*Particulars*	*L.F.*	*Dr. Amount[₹]*	*Cr. Amount [₹]*
2015 *March 1*	*Bill Receivable account Dr.* *To B* *[Being the bill drawn and accepted payable after two months]*		*7,000*	 *7,000*
April 1	*C Dr.* *To Bill Receivable account* *[Being the bill endorsed in favour of C]*		*7,000*	 *7,000*

Books of B

Journal Entries

Date	*Particulars*	*L.F.*	*Dr. Amount[₹]*	*Cr. Amount [₹]*
2015 *March 1*	*A Dr.* *To Bill Payable account* *[Being the bill accepted payable after two months]*		*7,000*	 *7,000*
May 4	*Bill Payable account Dr.* *To Cash account* *[Being the payment of the bill at maturity]*		*7,000*	 *7,000* *7,000*

Books of C

Journal Entries

Date	*Particulars*	*L.F.*	*Dr. Amount[₹.]*	*Cr. Amount [₹]*
2015 April 1	*Bill Receivable account Dr.*		*7,000*	
	To A			*7,000*
	[Being the endorsed bill received from A]			
May 4	*Cash account Dr.*		*7,000*	
	To Bill Receivable account			*7,000*
	[Being the bill realised on maturity]			

4.2.4 RETIRING THE BILL

Retiring a bills means making payment before the date of maturity. In order to encourage the acceptor to make payment as early as possible, it is a normal practice to allow him discount at a specified rate of interest for the period he is making payment too early. Such a discount is an expense to the party receiving the payment and gain to the party making the payment.

Drawer's books

Cash A/c Dr. Rs. ....

Discount [or Rebate] A/c Dr. Rs. ....

To Bills Receivable A/c Rs. ....

Acceptor's books

Bills Payable A/c Dr. Rs. ....

To Cash A/c Rs. ....

To Discount [or Rebate] A/c Rs. ....

Example : On 1st Jan, 2015, 'A' sells goods for Rs. 10,000 to 'B' and draws a bill at three months for the amount . B accepts it and returns it to A. On 1st March, 2015 B retires his acceptance under rebate of 12% per annum. Record these transactions in the Journals of A and B.

Books of A

Journal Entries

Date	Particulars	L.F.	Dr. Amount[₹]	Cr. Amount [₹]
2015 Jan 1	*B Dr.*		*10,000*	
	To Sales account			*10,000*
	[Being the goods sold to B on credit]			
	Bill Receivable account Dr.		*10,000*	
	To B			*10,000*
	[Being the acceptance of bill received]			
Mar 1	*Bank Account Dr.*		*9,900*	
	Rebate on Bills Account Dr.		*100*	
	To Bill Receivable Account			*10,000*
	[Being retirement of the bill by B one month before maturity, the rebate being given to him at 12% p. a.]			

Books of B

Journal Entries

Date	Particulars	L.F.	Dr. Amount[₹]	Cr. Amount [₹]
2015 Jan 1	*Purchase account Dr.*		*10,000*	
	To A			*10,000*
	[Being the goods purchased from A on credit]			
	A Dr.		*10,000*	
	To Bill Payable account			*10,000*
	[Being the acceptance of the bill given to A]			
Mar 1	*Bill Payable Account Dr.*		*10,000*	
	To Bank Account			*9,900*
	To Rebate on Bills Account			*100*
	[Being the bill discharged under rebate @ 12% p.a.]			

4.2.5 ACCOMMODATION BILL

Accommodation bills are bills drawn, accepted and negotiated for the temporary accommodation of either the drawer or the acceptor, or for the mutual accommodation of both. They are not the outcome of genuine business transactions. No valid consideration passes between the drawer of the bill and the acceptor and the purpose of the bill is served by raising the necessary amount by discounting it with the bankers. The discount is done by the parties in the proportions in which they share the proceeds.

Accommodation bills are accepted in the following three circumstances:

a. **When accommodation bill is written for the mutual accommodation of the drawer** then the drawee of the bill accepts the bills without any consideration and returns the bill to the drawer. The drawer gets the bill discounted with his banker and uses the total amount in his business. On the due date he remits the amount to the acceptor of the bill to enable him to honour the bill on the due date.

Example: On 1st Jan, 2015 'B' accepted a three months bill for Rs. 20,000 drawn on him by A for latter's benefit. A discounted the bill on 4th Jan @ 20% per annum and on the due date sent B a cheque for Rs. 20,000 in order to enable him to honour the Bill . B duly honoured his acceptance. Pass journal entries in the books of A and B.

Books of A

Journal Entries

Date	Particulars	L.F.	Dr. Amount[₹]	Cr. Amount [₹]
2015 Jan 1	Bill Receivable account Dr. To B [Being acceptance received payable after 3 months]		20,000	 20,000
Jan 4	Bank account Dr. Discount account Dr. To Bill Receivable account [Being the bill discounted with bank @ 20 % p.a.]		19,000 1,000	 20,000
April 4	B Dr. To Bank Account [Being cheque sent to B]		20,000	 20,000

Books of B

Journal Entries

Date	*Particulars*	*L.F.*	*Dr. Amount[₹]*	*Cr. Amount [₹]*
2015				
Jan 1	*A Dr.*		*20,000*	
	To Bill Payable account			*20,000*
	[Being the acceptance of the bill given payable after 3 months]			
Jan 4	*Bank account Dr.*		*20,000*	
	To A			*20,000*
	[Being cheque received from A]			
April 4	*Bill Payable Account Dr.*		*20,000*	
	To Bank Account			*20,000*
	[Being acceptance met on due date]			

b. **When accommodation bill is written for the mutual accommodation of the drawer and the drawee,** then drawee, after accepting the bill, returns it to the drawer. The drawer gets the bill discounted with his banker and after retaining the agreed portion of the proceeds of the bill remits the rest to the acceptor of the bill. On the date of the maturity the drawer of the bill remits to the acceptor the amount retained by him earlier to enable the acceptor to honour the bill. Discount will be shared in the same proportion in which proceeds have been shared.

Example: For the mutual accommodation of 'P' and 'Q', P draws a bill on Q for Rs. 15,000. Q accepts the bill and returns it to P. P discounts the same with his bankers and receives Rs. 14,640. The proceeds are shared between P and Q in proportion of 2/3 and 1/3 respectively. On the due date P remits his portion to Q who meets the bill. Pass journal entries in the books of P and Q to record the above transactions.

Books of P

Journal Entries

Date	*Particulars*	*L.F.*	*Dr. Amount[₹]*	*Cr. Amount [₹]*
	Bill Receivable account Dr.		*15,000*	
	To Q			*15,000*
	[Being the bill drawn on Q payable after-months]			
	Bank account Dr.		*14,640*	
	Discount account Dr.		*360*	

	To Bill Receivable account [Being the bill discounted with barkers at a discount of Rs. 360]			15,000
	Q Dr. To Bank Account To Discount account [Being 1/3 of the proceeds given to Q]		5,000	4,880 120
	Q Dr. To Bank Account [Being 1/3 of the total amount of the bill remitted to Q on maturity]		10,000	10,000

Books of Q

Journal Entries

Date	Particulars	L.F.	Dr. Amount[₹]	Cr. Amount [₹]
	P Dr. To Bill Payable account [Being the acceptance given to Q]		15,000	15,000
	Bank account Dr. Discount account Dr. To P [Being 1/3 of the proceeds received from P, 1/3 of the total discount amount debited to discount account]		4,880 120	6,000
	Bank Account Dr. To P [Being the balance amount received from P on maturityof the bill]		10,000	10,000
	Bill Payable Account Dr. To Bank Account [Being acceptance met on due date]		15,000	15,000

c. **When the drawer and the drawee write accommodation bills on each other:** In this case both the parties draw bills on each other and get them discounted from their bankers. On the due date each meets his own bill.

Example: On 1st Jan, 2015 'A' and 'B' drew on each other a bill for Rs. 10,000 payable 3 months after date for their mutual benefit. On 4th Jan, they discounted with their banks each other's bill at 20% per annum . on the due date, each met his own acceptance. Record transactions in the journals of A and B.

Books of A

Journal Entries

Date	*Particulars*	*L.F.*	*Dr. Amount[₹]*	*Cr. Amount [₹]*
2015				
Jan 1	*Bill Receivable account Dr.*		*10,000*	
	To B			*10,000*
	[Being the acceptance received payable after 3 months]			
Jan 4	*B Dr.*		*10,000*	
	To Bill Payable Account			*10,000*
	[Being the acceptance given to B payable after 3 months]			
Jan 4	*Bank account Dr.*		*9,500*	
	Discount account Dr.		*500*	
	To Bill Receivable account			*10,000*
	[Being the bill discounted @ 20% p.a. for 3 months]			
April 4	*Bill Payable account Dr.*		*10,000*	
	To Bank Account			*10,000*
	[Being acceptance met on the due date]			

Books of B

Journal Entries

Date	*Particulars*	*L.F.*	*Dr. Amount[₹]*	*Cr. Amount [₹]*
2015				
Jan 1	*A Dr.*		*10,000*	
	To Bill Payable account			*10,000*
	[Being the acceptance given to A payable after 3 months]			
Jan 1	*Bill Receivable Account Dr.*		*10,000*	
	To A			*10,000*
	[Being the acceptance received from A payable after 3 months]			
Jan 4	*Bank account Dr.*		*9,500*	
	Discount account Dr.		*500*	
	To Bill Receivable account			*10,000*
	[Being the bill discounted @ 20% p.a. for 3 months]			
April 4	*Bill Payable Account Dr.*		*10,000*	
	To Bank Account			*10,000*
	[Being acceptance met on due date]			

4.2.6 BILLS SENT FOR COLLECTION

Sometimes, the bill is neither endorsed nor discounted. Instead, it is sent for collection to the banker. In such a case, the sender of the bill opens a new account called 'Bills for Collection Account'. This account is debited when the bill is sent for collection and is credited when the intimation of actual collection is received from the banker. Any balance in this account stands for bills lying with the bankers as uncollected and warrants necessary action on that account. Entries are:

Books of Party:

i. When bill is sent for collection:

Bill for collection account	Dr.	Rs. ....
To Bill Receivable account		Rs. ....

ii. When bill is actually collected:

Bank Account	Dr.	Rs. ....
To Bill for collection account		Rs.

Books of Bank:

i. When bill is received for collection

Bill Receivable [Bill for Collection] A/c	Dr.	Rs. ....
To Bill for Collection account		Rs. ....

ii. When bill is collected: Two entries are made

a.	Cash account	Dr.	Rs. ....
	To Party	Rs.	
	[For collection of cash]		
b.	Bill for Collection account	Dr.	Rs. ....
	To Bill Receivable [Bill for collection account]		Rs. ....
	[For cancelling the original entry]		

Example: 'A' drew a bill on 'B' for Rs. 5,000 payable two months after date. Immediately after its acceptance, A sent the bill to his banker for collection. On the due date bank collects the bill and sends the advice of collection after deducting Rs. 25 as collection charges. Pass journal entries in the books of all parties.

Books of A

Journal Entries

Date	Particulars	L.F.	Dr. Amount[₹]	Cr.Amount [₹]
	Bill Receivable account Dr.		*5,000*	
	To B			*5,000*
	[Being the bill drawn on B payable after 2 months]			
	Bill for collection account Dr.		*5,000*	
	To Bill Receivable account			*5,000*
	[Being the bill sent to bankers for collection]			
	Bank account Dr.		*4,975*	
	Bank charges account Dr.		*25*	
	To Bills for collection Account			*5,000*
	[Being the collection of the bill amount by bankers after deducting Rs. 25 as collection charges]			

Books of B

Journal Entries

Date	Particulars	L.F.	Dr.Amount [₹]	Cr. Amount [₹]
	A Dr.		*5,000*	
	To Bill Payable account			*5,000*
	[Being the bill accepted payable after 2 months]			
	Bill Payable Account Dr.		*5,000*	
	To Cash Account			*5,000*
	[Being the bill duly met on maturity]			

Books of Book

Journal Entries

Date	*Particulars*	*L.F.*	*Dr. Amount[₹]*	*Cr. Amount [₹]*
	Bill Receivable account Dr.		*5,000*	
	To Bill for Collection A/c			*5,000*
	[Being bill received for collection]			
	Cash account Dr.		*5,000*	
	To A			*4,975*
	To Collection Charges A/c			*25*
	[Being the bill collected on the date of maturity, collection charges charged from A			
	Bill for Collection A/c Dr.		*5,000*	
	To bill Receivable A/c			*5,000*
	[Being the cancellation of the first entry on collection of the bill]			

4.3 BILL BOOK

Bill book is a book in which a person keeps an account of his notes, bills, bills of exchange, etc., thus showing all that he issues and receives.

For the drawer or the payee, a bill of exchange duly accepted is known as a bill receivable. For the drawee, the same is known as bill payable. A bill receivable is an example of current asset for the business while a bill payable is a current liability. On the other hand a promissory note is a bill receivable for the payee and a bill payable for the maker or the promisor. Thus, a bill is regarded as a bill receivable by one who is entitled to receive the sum of money due on its. It may have been drawn by him and accepted by his debtor, or it may be a bill which is debtor has endorsed to him in lieu of payment of his debt. Similarly, a bill of exchange is treated as a bill payable by one who is liable to pay the amount on the due date. Thus, the same bill is a bill receivable to one party and a bill payable to the other.

In large business undertakings, the number of bill transactions are numerous. It is desirable to have separate subsidiary books [special journal] known as Bills Receivable Journal and Bills Payable Journal. These special Journal are earmarked for recording only bill transactions.

4.3.1 RECORDING IN BILLS RECEIVABLE JOURNAL AND ITS POSTING

Bills receivable journal is part ofsubsidiary books in which we record all bills whose payment, we have to get from our customer at the time of maturity. In this book, we write S.No., date of receipt of bills, from whom we received these bills, due date, amount and remarks. It is used to record the bills received from debtors. When a bill is received, details of it are recorded in the bills receivable journal.

Posting:

In the ledger the account of the person from whom each bill is received is credited with the amount of that bill and the periodical total of the book is posted to the debit of bills receivable account. The bills receivable book is ruled according to the requirements of a particular account.

Format of Bills Receivable Journal:

The following is the format of bills receivable journal:

Bills Receivable Book

S.No.	Date received	Party From whom received	Acceptor	Date of Bill	Due date of the Bill	Place Where to be paid	Term of Bill	L.F.	Amount	How Disposed

4.3.2 RECORDING IN BILLS PAYABLE JOURNAL AND ITS POSTING

Bills payable journal is used to record bill accepted by us. When a bill drawn by our creditor is accepted, particulars of the same are recorded in this book.

Posting:

In the ledger, the account of each person whose bill has been accepted is debited with the amount of the bill. The monthly total of the bills accepted is credited to the bills payable account ledger.

Format of Bills Payable Journal:

The following is the ruling and format of bills payable book:

Bills Payable Book

S. No	Date of acceptance	Date of the bill	To whom given	Term of the bill	Due date of the bill	Place where to be paid	Payee	L.F.	Amount	How Disposed

Bills receivable is a current asset and appears on the 'asset' side of the Balance sheet while Bill payable is a current liability and appears on the 'liabilities' side of the balance sheet.

4.4 SUMMARY

When a seller sells goods to a customer on credit, the customer or debtor gives a bill of exchange duly accepted by him or a promissory note to the seller or creditor. This is known as 'bill receivable' because the creditor has to receive payment on these bills on maturity. From the debtor's point of view, they are called 'bills payable', because they have to make the payment to the creditor. When bill transactions are very large and frequent, separate subsidiary books or special journals , viz, 'Bills Receivable Journal' and 'Bills Payable Journal', are kept.

Accommodation Bills are drawn and accepted to help business friends who are temporarily in need of funds. They are bills of exchange for which no consideration is given by the drawer to the acceptor. The accounting treatment for an accommodation bill is the same as for an ordinary trade bill. But when cash is sent by the drawer to the acceptor or vice cersa, additional journal entries for this purpose are passed.

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SELF ASSESMENT QUESTIONS

1. Differentiate between a Bills of Exchange and a Promissory note.

2. Give a specimen with atleast five entries of i.) A Bill Receivable Book ii.) A Bills Payable Book. You are also required to make the posting of these entries in the ledger.

3. Differentiate between

    a. A trade bill and an accommodation bill.

    b. Retiring of bill and renewal of bill.

Uttar Pradesh Rajarshi Tandon Open University

Bachelor of BusinessAdministration

BBA-106

Financial Accounting

BLOCK

2

FINAL ACCOUNTS

UNIT-5

Concept Relating to Final Accounts

UNIT-6

Final Accounts-I

UNIT-7

Final Accounts-II

UNIT-8

Errors and their Rectification

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UNIT-05 CONCEPT RELATING TO FINAL ACCOUNTS

Objectives :

After going through this unit, you must be able to understand:

- The different accounting concepts.
- The importance of different accounting concepts.
- Understand the meaning of capital income and revenue income.
- The difference between capital expenditure and revenue expenditure

Structure :

5.1 BASIC CONCEPTS RELATING TO FINAL ACCOUNTS

Accounting Concepts and Principles are a set of broad conventions that have been devised to provide a basic framework for financial reporting. As financial reporting involves significant professional judgments by accountants, these concepts and principles ensure that the users of financial information are not misled by the adoption of accounting policies and practices that go against the spirit of the accountancy profession. Accountants must, therefore, actively consider whether the accounting treatments adopted are consistent with the accounting concepts and principles.

These are the necessary assumptions or conditions upon which accounting is based. Accounting concepts are postulates, assumptions or conditions upon which accounting records and statements are based.

5.1.1 GOING CONCERN CONCEPT

According to this concept it is assumed that the business will continue for a fairly long time to come. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future. On account of this concept, the accountant while valuing the assets does not take into account forced sale value of assets. Moreover, he charges depreciation on fixed assets on the basis of their expected lives rather than on their market value.

The 'Going Concern Concept' does not imply permanent continuance of the enterprise. It rather presumes that the enterprise will continue in operation long enough to charge against income, the cost of fixed assets over their useful lives, to amortize over appropriate period other costs which have been deferred under the actual or matching concept, to pay liabilities when they become due and to meet the contractual commitments. Moreover the concept applies to the business as a whole. When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going concern is normally not impaired.

The enterprise will not be considered as a going concern when it has gone into liquidation or it has become insolvent. Of course, the receiver or the liquidator may endeavour to carry on business operations for some period pending arrangement with the creditors or final buyer for the sale of the business as a going concern, the going concern status of the concern will stand terminated from the date of his appointment or will be at least regarded as suspended, pending the results of his efforts.

5.1.2 ACCOUNTING PERIOD CONCEPT

According to this concept, the life of the business is divided into appropriate segments for studying the results shown by the business after each segment. This is because though the life of the business is considered to be indefinite [according to going concern concept], the measurement of income and studying the financial9* position of the business after a very long period would not be helpful in taking proper corrective steps at the appropriate time. It is, therefore, absolutely necessary that after each segment or time interval the businessman must 'stop' and 'see back', how things are going. In accounting such a segment or time interval is called 'accounting period'. It is usually of a year.

At the end of each accounting period an Income Statement and a Balance Sheet are prepared. The Income Statement discloses the profit or loss made by the business during the accounting period while the Balance Sheet depicts the financial position of the business as on the last day of the accounting period. While preparing these statements a proper distinction has to be made between capital and revenue expenditure.

5.1.3 MATCHING CONCEPT

This is based on the accounting period concept. The paramount objective of running a business is to earn profit. In order to ascertain the profit made by the business during a period, it is necessary that 'revenues' of the period should be matched with the cost [expenses] of the period. The term 'matching' means appropriate association of realised revenues and expenses. In other words, income made by the business during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. The question when the payment was received or made is 'irrelevant'. On account of this concept, adjustments are made for all outstanding expenses, accrued incomes, prepaid expenses and unearned incomes etc. while preparing the final accounts at the end of the accounting period.

5.1.4 CONSERVATISM CONCEPT

In the initial stages of accounting, certain anticipated profits which were recorded, did not materialise. This resulted in less acceptability of accounting figures by the end users. On account of this reason, the accountants follows the rule 'anticipate no profit but provide for all possible losses' while recording business transactions. In other words, the accountant follows the policy of 'playing safe'. On account of this convention, the inventory is valued 'at cost or market price whichever is less'. Similarly a provision is made for possible bad and doubtful debts out of current year's profits. This concept affects principally the category of current assets. The convention of conservatism has become target of serious criticism these days especially on the ground that it goes against the convention of full disclosure. It encourages the accountant to create secret reserves [e.g. by creating excess provision for bad and doubtful debts, depreciation etc.] and the financial statements do not depict a true and fair view of state of affairs ofthe business. The Income Statement shows a lower net income, the Balance Sheet understates assets and overstates liabilities.

The research studies conducted by the American Institute of Certified Public Accountants have indicated that conservatism concept needs to be applied with much more caution and care if the results reported are not to be distorted.

5.1.5 CONSISTENCY CONCEPT

According to this convention accounting practices should remain unchanged from one period to another. For example, if stock is valued at 'cost or market price whichever is less', this principle should be followed year after year. Similarly if depreciationis charged on fixed assets according to diminishing balance method, it should be done year after year. This is necessary for the purposes of comparison. However, consistency does not mean inflexibility. It does not forbid introduction of improved accounting techniques. However, if adoption of such a technique results in inflating or deflating the figures of profit as compared to the previous period, a note to that effect should be given in the financial statements.

5.1.6 FULL DISCLOSURE CONCEPT

According to this convention accounting reports should disclose fully and fairly the information they purport to represent. They should be honestly prepared and sufficiently disclose information which is of material interest to proprietors, present and potential creditors and investors. The convention is gaining more importance because most of big businesses are run by joint stock companies where ownership is divorced from management. The Companies Act 2013, not only requires that Income Statement and Balance Sheet of a company must give a true and fair view of the state of affairs of the company, but it also gives the prescribed forms in which these statements are to be prepared. The practice of appending notes to the accounting statements [such as about contingent liabilities or market value of investments] is in pursuant to the convention of full disclosure.

5.1.7 MATERIALITY CONCEPT

According to this convention the accountant should attach importance to material details and ignore insignificant details. This is because otherwise accounting will be unnecessarily overburdened with minute details. The question what constitutes a material detail, is left to the discretion of the accountant. Moreover, an item may be material for one purpose while immaterial for another. For example, while sending each debtor ‘a statement of his account’, complete details have to be given. However, when a statement of outstanding debtors is prepared for sending to top management figures may be rounded to the nearest ten or hundred. The Companies Act also permits ignoring of ‘paise’ while preparing financial statements. Similarly for tax purposes, the income has to be rounded to nearest ten.

Thus, the term ‘materiality’ is a subjective term. The accountant should regard an item as material if there is reason to believe that knowledge of it would influence the decision of the informed investor. According to Kohler, ‘materiality means the characteristic attaching to a statement, fact or item whereby its disclosure or method of giving it expression would be likely to influence the judgement of a reasonable person.’

5.2 BASES OF ACCOUNTING DISTINCTION BETWEEN CAPITAL AND REVENUE

Income can be classified into two categories:

1. **Capital income:** It means an income which does not grow out of or pertain to the running of the business properly. It is synonymous to the term ‘capital gain’. However, only profit realised over and above the cost

of the fixed asset should be taken as capital profit. The profit realised over and above book value of the asset till it does not exceed the original cost of the asset should be taken as a revenue profit though it does not strictly arise out of and in the course of regular business transaction.

2. **Revenue income:** It means an income which arises out of and in the course of the regular business transactions of a concern. For example, in the course of running a business, the profit is made on sale of goods, income is received from letting out the business property, dividends are received on business investments etc. All such incomes are revenue incomes. It should be noted that the terms 'Revenue profit' and 'Revenue income' are synonymous.

5.2.1 CAPITAL AND REVENUE EXPENDITURE

Expenditure can be classified into three categories:

a. Capital expenditure

b. Revenue Expenditure

c. Deferred revenue expenditure

Capital expenditure -

A capital expenditure is one which increases the value at which a fixed, or capital asset may properly be carried on in the books. All expenditure which results in the acquisition of permanent assets which are intended to be continually used in the business for the purpose of earning revenue is capital expenditure. The term capital expenditure is generally used to signify that expenditure which

a. **Increases quantity of fixed asset-** An addition increases the quantity of fixed asset. Hence amount spent on the purchase of fixed asset is treated as capital expenditure;

b. **Increases quality of fixed assets-** The quality of a fixed asset is said to have increased when expenditure results in any or some of the following events:

    1. When probable useful life of the fixed asset increases;
    2. When capacity of the fixed asset increases;
    3. When efficiency of the fixed asset increases;
    4. When operating economy is achieved;
    5. When quantity of its output increases beyond that originally anticipated

c. **Results in the replacement of fixed assets-** This involves a substitution of a new asset or asset component for part or all of an existing asset.

Following are the examples of capital expenditure:

1. Expenditure resulting in the acquisition oflong –lived [fixed] assets. e.g. - land, building, machinery, furniture, motor, car, trade marks.
2. Expenditure resulting in extension or improvement of fixed assets. e.g. amount spent on increasing the seating accommodation in the picture hall.
3. Expenditure in connection with the purchase, receipt, or erection of a fixed asset. e.g.- wages paid or expenses on the erection of plant and machinery, expenses on cartage, insurance of a fixed asset.
4. Major repairs and replacement of parts resulting in increased efficiency of a fixed asset.
5. Expenditure incurred for acquiring the right to carry on a business e.g. patent, rights, copyrights, goodwill.
6. 'Used' property that is acquired usually requires expenditure for rehabilitating or reconditioning to restore its efficient operating state.
7. Legal charges and Stamp duty paid for conveyancing on acquisition of a property.
8. Architect fees paid for supervising construction of a property.
9. Cost of stand-by equipment and servicing equipment
10. Cost of experimenting when the same results ultimately in acquisition of a patent.

Revenue expenditure :

An amount spent for earning or providing revenue is called a revenue expenditure. A revenue expenditure is one which constitute a proper deduction from income or revenue. It is an expense. In other words, all establishment and other expenses incurred in the conduct and administration of the business come under the heading of revenue expenditure. All expenses incurred by way of repairs, replacement of existing assets, which do not in any way add to their earning capacity but simply serve to maintain the original equipment in an efficient working order are charged to revenue. Examples are:

1. Expenses incurred in the normal course of business, e.g. expenses of administration, expenses incurred in manufacturing and selling products. Examples of such expenses are salaries; rent, insurance, postage, stationery, repairs to assets.
2. Expenses incurred to maintain the business, e.g. replacements for maintaining the existing permanent assets, cost of stores consumed in the course of manufacturing, e.g. oil, cotton-waste, machinery spares consumed.
3. Cost of goods purchased for resale.
4. Depreciation on fixed assets, interest on loans for business, loss from sale of fixed asset.

5. Obsolescence cost.

All items of revenue expenditure are debited to profit and loss account while all items of capital expenditure are recorded in balance sheet. Wrong classification of capital and revenue items will lead to falsification of these two statements. If an item of revenue expenditure is debited to an asset account, it will inflate or overstate the profits. On the other hand, if an item of capital expenditure is debited to profit and loss account, it will understate the profits of a particular period.

Distinction between capital and revenue expenditure:

The following are the points of distinction between a capital expenditure and revenue expenditure:

a. Capital expenditure is incurred for acquisition of fixed assets for the business. While revenue expenditure is incurred for day-to-day operation of the business.

b. Capital expenditure is incurred for increasing the earning capacity of the business while revenue expenditure is incurred for maintaining the earning capacity of the business.

c. Capital expenditure is of non-recurring nature while revenue expenditure is of a recurring nature.

d. The benefit of capital expenditure is received over a number of years and only a small part of it, as depreciation, is charged to the profit and loss account each year. The rest appears in the balance sheet as an asset. While the benefit of revenue expenditure expires in the year in which the expenditure is incurred and it is entirely charged to the profit and loss account of the relevant year.

Revenue expenditure that becomes capital expenditure: Following are some of the circumstances under which an expenditure which is usually of a revenue nature may be taken as an expenditure of a capital nature

1. **Repairs:** The amount spent on repairs of plant, furniture, building etc. is usually taken as a revenue expenditure. However, when a second –hand plant or motor-car is purchased, the expenditure incurred for immediate repairs of such a plant or motor car to make it fit for use will be taken as a capital expenditure.

2. **Wages:** The amount spent as wages is usually taken as a revenue expenditure. However, wages paid for erection of a new plant or machinery or wages paid to workmen engaged in construction of a fixed asset are taken as expenditure of a capital nature.

3. **Legal charges:** These are usually taken as expenditure of a revenue nature, but legal charges incurred in connection with purchase of fixed assets should be taken as part of the cost of the fixed asset.

4. **Transport charges**: These are generally of a revenue nature, but transport charges incurred for a new plant or machinery are taken as expenditure of a capital nature and are added to the cost of the asset

5. **Interest on capital**: Interest on capital paid during the construction of works, building, or plant may be capitalised and thus added to the cost of the asset concerned.

6. **Raw material and stores**: They are usually taken as revenue expenditure, but raw materials and stores consumed in construction of fixed assets should be treated as capital expenditure and be taken as a part of the cost of such fixed asset.

7. **Development expenditure**: In case of industries like tea, rubber, plantations, horticulture, etc. a long period is required for development. The expenditure incurred during such period is termed as development expenditure and may be treated as capital expenditure. however once the industries begin operation, the expenditure incurred to maintain them will be revenue expenditure.

8. **Advertising**: Cost of advertising for the purpose of introducing a new product should be treated as capital expenditure, since the benefit of such expenditure will be available only in future years.

9. **Preliminary expenses** Expenses incurred in formation of a new company are termed as preliminary expenses and should be treated as capital expenditure.

Example: State with reason whether the following are Capital or Revenue Expenditure:

e. *Freight and cartage on the new machine Rs. 150, erection charges Rs. 200.*

f. *Fixtures of the book value of Rs. 1,500 were sold off at Rs. 600 and new fixtures of the value of Rs. 1,000 were acquired, cartage on purchases Rs.5*

g. *A sum of Rs. 100 was spent on painting the factory*

h. *Rs. 5,150 spent on repairs before using a second hand car purchased recently, to put it in usable condition.*

Solution:

a. *Freight, cartage and erection charges Rs. 350 [Rs. 150+200] on new machine are capital expenditure, since these expenditure are incurred up to the point machine is ready for use.*

b. *Loss of Rs. 900 [Rs. 1,50θ 600] on the sale of fixtures will be treated as revenue expenses being diminution in the value of an asset due to wea and tear or passage of time but the cost of new fixture Rs. 1,000 together with cartage Rs.5 will be treated as capital expenditure since this is the expenditure incurred on acquisition of the fixed asset.*

c. *Painting charges Rs. 100 are maintenance charges, and will be treated as revenue expenditure since it is incurred on maintenance of the factory in good condition.*

d. *Rs. 5,150 has been spent on repairs in order to bring the asset in usable condition. Hence this is capital expenditure.*

5.2.2 DEFERRED REVENUE EXPENDITURE

A heavy expenditure of revenue nature incurred for getting benefit over a number of years is classified as deferred revenue expenditure. Preliminary expenses, brokerage on issue of shares and debentures, discount on issue of shares and debentures, exceptional repairs, heavy advertisement, expenses incurred in removing the business to more convenient premises are examples of such expenses which are essential for carrying on the business and thus revenue in nature. Nevertheless, the formidable amount of these expenses does not permit to write it off from the profit of one financial year as it will, if attempted, wipe off the complete or major portion of the profit. In order to maintain steady growth, it is desirable that such expenses may be taken to profit and loss account in part every year and thus unwritten off portion may be allowed to stand in the balance sheet on the asset side. This treatment is also justifiable on the ground that benefit of such expenses is likely to extend beyond the year in which it takes place and each of these years concerned be burdened with a proportionate share of such expense, and not the whole amount be charged off to the profit and loss account of the very year in which it had been so expended.

Pickles and Dunkerley have, in their book 'Accountancy', classified it into four distinct types as follows:

i. Expenditure wholly paid for in advance, where no service has yet been rendered necessitating it being carried forward, i.e. the showing of such outlay as an asset in the Balance sheet as prepaid expenditure. e.g. telephone rental or office rent paid in advance etc.

j. Expenditure partly paid in advance where a portion of the benefit has been derived within the period under review the balancing being as yet 'unused' and, therefore, shown in the balance sheet as an asset, e.g. proportion of rates paid in advance or special advertising expenditure incurred in introducing a new-line or developing a new market.

k. Expenditure in respect of service rendered which for any reason is considered as an asset, or more properly, is not considered to be allocable to the period in question. e.g. development costs in mines and plantation, discount on debentures and cost of experiments

l. Amount representing losses of an exceptional nature, e.g. property, confiscated in a foreign country, heavy loss of non insured assets through fire, etc.

5.2.3 CAPITAL AND REVENUE RECEIPTS

As it is necessary to distinguish between capital and revenue expenditure in the same way it is necessary to make proper distinction between capital and revenue receipts.

Capital receipts consist of additional payments made to the business either by shareholders of the company or by the proprietors of the business, or receipts from sale of fixed assets of a business. For example, the amount raised by the company by way of share capital is a capital receipt. Similarly, if a firm sells its machinery for a sum of Rs. 10,000, the receipt is a capital receipt. Capital receipt is different from a capital profit. Receipt denotes receiving payments in cash. Moreover, the whole of it may or may not be a capital profit. There may be a capital loss too. For example, if plant costing Rs. 10,000 is sold for Rs. 12,000, there is a capital receipts of Rs. 12,000 but there will be capital profit of only Rs. 2,000.

Money obtained in the course of business are revenue receipts. Examples are: money obtained from the sale of goods, interest on deposits, dividends on investments. In a business most of the receipts are revenue receipts. However, a revenue receipts is also different from revenue profit or revenue income. Receipts denote receiving of payment in cash. Moreover, the entire amount of receipts may or may not be revenue income. For example, if goods costing Rs. 20,000 are sold for Rs. 25,000, there is a revenue receipts of Rs. 25,000 but revenue profit or income is only Rs. 5,000.

Capital receipts are shown in the balance sheet and revenue receipts in the profit and loss account. Moneys obtained from the sale of fixed assets or investments, issue of shares, debentures, money obtained by way of loan are examples of capital receipts.

Example: State in each of the following cases whether the expenditure is a 'capital expenditure', or 'revenue expenditure' or 'deferred revenue expenditure'.

a. *Legal expenses incurred to defend a suit for breach of a contract to supply goods.*
b. *Custom duty paid on imported machinery.*
c. *Heavy expenditure incurred on advertising a new product.*
d. *Amount spent to overhaul a motor truck purchased second hand.*
e. *Wages paid to workers for setting up a new machinery.*
f. *Wages paid to workers for converting raw material into finished goods.*
g. *Office rent paid in advance for three years.*
h. *Expenditure on development of a product.*

Solution:

a. *Revenue expenditure. It is an expenditure incurred in the normal course of business*
b. *Capital expenditure. It necessarily adds to the cost of imported machinery*
c. *Deferred revenue expenditure. The benefit of this expenditure will be available for a number of years. The proportionate amount will be written off every year.*

d. *Capital expenditure. The expenditure incurred will improve the present condition of the motor truck.*

e. *Capital expenditure. This is an expenditure incurred to put an asset into working condition. Such expenditure is capitalised and is added to the cost of the asset.*

f. *Revenue expenditure. The expenditure has benn incurred in the normal course of day-to-day business.*

g. *Deferred revenue expenditure. The right does not expire in the accounting period in which it is paid but will expire within a fairly short period of time. Only a portion of the total office rent paid should be treated as a revenue expenditure [portion relating to the current period] and the balance should be carried forward as an asset to be written off in subsequent years.*

h. *Revenue expenditure. The expenditure incurred has been in the normal course of business.*

5.3 SUMMARY

Accounting concepts provide the conceptual guidelines for application in the financial accounting process. Going concern concept assumes that an accounting entity will continue in operation in the absence of evidence to the contrary. Accounting period concept implies that the financial accounting provides information about the economic activities of an enterprise for specific time period, that are shorter than the life of the enterprise. The conservatism principle is described as 'anticipate no profit, and provide for all possible losses'. Matching concept is the process of matching revenues with expenses to a particular period for which the income is being determined. The consistency concept requires that once an organization has decided on one method, it should use the same method for all subsequent transactions and events of the same nature unless it has sound reason to change methods. The Materiality concept implies that only material transactions and events should be recorded and reported in financial statements. The concept of full disclosure requires that business enterprises should provide all relevant information to external users for the purpose of sound economic decisions.

The distinction between capital and revenue is important both for income determination and taxation purposes. Proper classification of capital and revenue items should be made. All items of revenue nature are taken to profit and loss account and all items of capital nature are taken to balance sheet. If there is incorrect classification of these items, profit or loss figure as revealed in profit and loss account will be wrong. Expenditure incurred on acquisition of an asset, or putting new asset in working condition is capital expenditure. Expenditure incurred to acquire raw materials or finished goods, to maintain assets in working order is revenue expenditure. A heavy expenditure of revenue nature e.g. exceptional repairs to a fixed asset, advertisement expenses, preliminary expenses are examples of deferred revenue expenditure.

5.4 REFERENCES

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SELF ASSESMENT QUESTIONS

1. Explain briefly the various concepts of accounting and their importance.
2. Why is the difference between capital and revenue of great importance in accounting? Give examples illustrating how certain expenditure can be regarded as a capital expenditure as well as revenue expenditure under different circumstances.
3. State the consideration which would guide you in deciding whether any particular item should be regarded as of a capital nature or of a revenue nature.
4. Describe deferred revenue expenditure.

UNIT-06 FINAL ACCOUNTS-I

Objectives :

After going through this unit, you must be able to understand:

- Why final accounts are prepared.
- Preparation of Trading account, Profit & Loss account, and Balance Sheet.
- Handling of different items in the preparation of Final accounts.
- The meaning, the technique, form, principles involved in preparation of Trading account, Profit & Loss account, and Balance Sheet.
- The difference between trial balance and balance sheet.
- Why and how closing entries are passed in final accounts.
- How final accounts can be presented in vertical form.

Structure :

6.1 FINAL ACCOUNTS AND TRIAL BALANCE

Final Accounts:

Money is invested in a business with the primary aim of earning profits. For knowing this, it is necessary that the accountant must measure and accumulate accounting data in such a manner that the amount of profit earned or loss suffered by the business may be determined and reported. For the purpose of determining the profit or loss figure, a statement known as trading and profit and loss account [or income statement]is prepared at the end of the year which includes all figures in detail. Thus, all items of expenses and losses and all revenues and gains occurring during the accounting period are reported in profit and loss account. This account or income statement is divided into two parts- first part is called **Trading Account** and second part is called **Profit and Loss Account**.

Another statement- **Balance Sheet** [or Position Statement] – is also prepared with an aim to know the exact financial position of the business on the last date of the accounting period. These two statements –trading and profit & loss accounts and balance sheet – are known as financial statements or Final accounts, because they are the end-product of the financial accounting process. Both these statements are prepared from the balances appearing in the trial balance extracted from ledger accounts as on the last date of the accounting period. After the preparation of trading and profit & loss accounts, balances remaining in the trial balance represent either asset or liabilities existing on the last day of the accounting period. These assets and liabilities are arranged in a proper way and the resultant statement is called a balance sheet.

Preparation of Final accounts:

Final accounts viz, trading and profit & loss account and balance sheet are prepared from the balances appearing in the trial balance at the end of an accounting period. In order to decide the place where the particular balance should be taken, following rules may be noted:

1. **For the debit side of the trial balance**: Balance appearing on the debit side of the trial balance may either be a loss or expense or an asset. If the debit balance of the account represents such an item that it is likely to benefit in the future, then it is an asset and is taken to the asset side of the balance sheet. If the balance of the account is such that the benefit out of it has already expired then it is an expense and is taken to the debit side of trading account or profit and loss account as the case may be.

2. **For the credit side of trial balance**: Balance appearing on the credit side of the trial balance may either be a gain or a revenue or a liability. If the credit balance of the account is payable then it is a liability and is taken to the balance sheet. If the balance is not payable then it is a gain or revenue and is taken to the trading account or the profit and loss account, as the case may be.

6.2 TRADING ACCOUNT

Trading account is compiled from the trial balance; or a list of accounts taken from the Nominal or General Leger monthly, quarterly or annually. The aim of this account is to find out the gross profit or gross loss. Trading account gives the overall result of trading i.e. purchasing and selling of goods. It explains whether purchasing of goods and selling them have proved to be profitable for the business or not. It takes into account on the one hand the cost of goods sold and on the other the value for which they have been sold away. In case the sales value is higher than the cost of goods sold, there will be a profit, while in a reverse case, there will be a loss. The profit disclosed by the trading account is termed as 'gross profit', similarly the loss disclosed by the trading account is termed as 'gross loss'.

Importance of Trading Account:

1. Gross profit disclosed by the Trading account tells about the upper limit within which the businessman should keep the operating expenses of the business besides saving something for himself. The cost of purchasing and the price at which he can sell the goods are governed by the market factors over which he has no control. He can control only his operating expenses.

2. The business can calculate the gross profit ratio and compare its performance year after year. A fall in the gross profit ratio means either an increase in the cost of purchasing the goods or a decrease in the selling price of the goods, or both. In order to maintain at least the same figure of gross profit in absolute terms, the business has to push up the sales or make all efforts to obtain goods at cheaper prices, thus, it can prevent at least fall in the figure of its gross profit if cannot bring any increase in it.

3. Comparison of stock figures of one period with another will help prevent unnecessary lock up of funds in inventories.

4. In the case of new products, the business can fix up the selling price of the products by adding to the cost of purchase the percentage gross profit that it would like to maintain.

Important Points Regarding Trading account:

1. **Stock :** the term 'stock' includes goods lying unsold on a particular date. The stock may be of two types:

   a. **Opening stock:** It means goods lying unsold with the businessman in the beginning of the accounting year. This is shown on the debit side of the Trading account.

   b. **Closing stock:** It includes goods lying unsold with the businessman at the end of the accounting year. Stock at the end of the accounting year is taken after the books of the accounts have been closed. The amount of closing stock is shown on the credit side of the Trading account and as asset in the balance sheet. The closing stock at the end of the accounting period will become the opening stock for the next year.

2. **Purchases:** They include both cash and credit purchases of goods. The term 'goods' means item purchased for resale. Assets purchased for permanent use in the business such as purchase of plant, furniture etc. are not included in the purchase of goods.

3. **Sales:** They include both cash and credit sales. Gross sales will be shown in the inner column of the trading account out of which 'sales return' will be deducted. The net sales will be then shown in the outer column of the Trading account. Sales of assets like plant and machinery, land and building or such other assets which were purchased for using in the business and not for sale, should not be included in the figure of 'sales'to be taken to the Trading account.

4. **Wages:** The amount of wages is taken as a direct expense and therefore, is debited to Trading account. If the trial balance shows 'wages and salaries', the amount is taken to the trading account. however, if the trial balance shows 'salaries and wages', the amount is taken to the profit & loss account.

5. **Customs and import duty:** In case the goods have been imported from outside the country, customs and import duty may have to be paid. The amount of such duty should be charged to the trading account

6. **Freight, carriage and cartage:** These are taken as direct expenses incurred on purchasing of the goods. They are, therefore, taken to the debit side of the Trading account. The terms 'freight inward or freight in', 'carriage inward or carriage in', and 'cartage inward or cartage in', have also the same meaning. However, 'freight outward or freight out', 'carriage outward or carriage out', and 'cartage outward or cartage out', are taken to be the expenses incurred on selling the goods. They are, therefore, charged to the profit & loss account.

7. **Royalty:** It is the amount paid to the owner for using his rights. It is generally taken as a direct expense and therefore, is charged to the Trading account.

8. **Gas, electricity, water, fuel etc.**: All these expenses are direct expenses and are charged to the Trading account.

9. **Packing materials:** Material used for packing the goods purchased for bringing them to the shop or convert them into a saleable state are direct expenses and they are charged to the Trading account.

Format of Trading Account

Particulars	**Amount ₹**	**Particulars**	**Amount ₹**
To Opening stock	****	By Sales ***	
To Purchases ***		Less: Sales return **	****
Less: Purchase return **	****	By Closing stock	****
To Direct expenses	****	By Gross Loss c/d	****
To Wages	****		
To Carriage inward	****		
To Wages and salary	****		
To Factory rent	****		
To Gross Profit c/d	****		
Total:	****	Total	****

Example: Prepare a Trading account from the following information of Mr. Murugam for the year ending 31st March 2015.

Particulars	***Amount***	***Particulars***	***Amount***
Opening stock	*5,900*	*Sales*	*6,020*
Closing stock	*8,950*	*Return inwards*	*250*
Purchases	*6,200*	*Wages*	*240*
Return Outward	*610*	*Carriage on purchases*	*50*

Solution:

Trading Account of Mr. Murugan

For the year ending 31st March, 2015

Particulars	***Amount ₹***	***Particulars***	***Amount ₹***
To Opening stock	*5,900*	*By Sales 6,020*	
To Purchases 6,200		*Les: Return inwards 250*	*5,770*
Less: Return Outward 610	*5,590*		*8,950*
To Wages	*240*	*By Closing stock*	
To Carriage on purchases	*50*		
To Gross Profit c/d	*2,940*		
Total	***14,720***	*Total*	***14,720***

6.3 PROFIT AND LOSS ACCOUNTS

Trading account disclose the profit or loss made by a businessman on purchasing and selling of goods. It does not consider other operating expenses incurred by him during the course of his business. All such expenses are charged to Profit and Loss Account. The main objective of Profit & Loss account is to calculate net profit, or the surplus remaining after charging all the expenses against gross profit, including depreciation and other provisions properly attributable to the normal activities of a particular business. In the words of Prof. Carter, "Profit & Loss Account is an account into which all gains and losses are collected in order to ascertain the excess of gains over the losses, or vice versa."

Preparation of Profit & Loss Account:

Profit & Loss Account is an account and its form and construction conform to the rules of Ledger Account and the principle of Double Entry System. But for the practical purpose, the Profit & Loss Account is prepared as a continuation of the trading account, and not as a separate account. Profit & Loss Account starts with gross profit brought down from trading account on the credit side and, if it is loss , then on the debit side. All the indirect expenses are debited and all the revenue incomes are credited to the Profit & Loss Account and then the net profit or loss is calculated. If income or credit is more than the expenses or debit, the difference is net profit; whereas if the expenses or debit side is more, the difference is net loss.

Importance of Profit and Loss Account

1. It provides information about the net profit earned or net loss suffered by the business during a particular period.

2. The profit figure disclosed by the Profit & Loss Account for a particular period can be compared with that of the other period. Thus, it helps in ascertaining whether the business is being run efficiently or not.

3. An analysis of the various expenses included in the Profit & Loss Account and their comparison with the expenses of the previous period or periods helps in taking steps for effective control of the various expenses.

4. Allocation of profit among the different periods or setting aside a part of the profit for future contingencies can be done. Moreover, on the basis of profit figures of the current and the previous period, estimates about the profit in the year to come can be made. These projection will help the business in planning the future course of action.

Important points regarding Profit & Loss Account

1. **Gross profit or Gross Loss:** The figure of gross profit or gross loss is brought down from the trading account.

2. **Salaries:** Salaries payable to the employees for the services rendered by them in running the business being of indirect nature are charged to the Profit & Loss Account.

3. **Salaries less tax:** In case of employees earning salaries beyond a certain limit, the employer has to deduct at source income tax from the salaries of such employees. In such a case, the amount of gross salaries should be charged to the Profit & Loss Account, while the tax deducted by the employer will, be shown as a liability in the balance sheet of the business till it is deposited with the Tax Authorities.

4. **Interest:** Interest on loans whether short-term or long-term is an expense of an indirect nature and, therefore, is charged to the Profit & Loss Account. However, interest on loans advanced by a firm to third-parties is an item of income and therefore, will be credited to the Profit & Loss Account.

5. **Commission:** Commission on business brought by agents is an item of expense, while commission earned by the business for giving business to others is an item of income. Commission to agents is, therefore, debited to Profit & Loss Account while commission received is credited to the Profit & Loss Account.

6. **Printing and stationary:** This item of expense includes expenses on printing of bills, invoices, registers, files, letterheads, ink, pencil, paper and other items of stationary etc. It is of an indirect nature and therefore, charged to th e Profit & Loss Account.

7. **Trade expenses:** They are expenses of a miscellaneous nature. They are of small amount and varied in nature and, therefore, it is not considered worthwhile to open separate account for each of such type of expenses. The term 'Sundry Expenses', 'Miscellaneous Expenses' or 'Petty Expenses' have also the same meaning. They are charged to the Profit & Loss Account.

8. **Advertisements:** advertisement expenses are incurred for attracting the customers to the shop and therefore, they are taken as selling expenses. They are debited to the Profit & Loss Account.

9. **Bad debts:** It denotes the amount lost from debtors to whom the goods were sold on credit. It is loss and therefore should be debited to the Profit & Loss Account.

10. **Depreciation:** It denotes decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. It is necessary that depreciation is charged to the Profit & Loss Account to ascertain the true profit or loss made by the business.

11. **Discount:** It is a reduction from a list price, quoted price, or invoice price.

Format of Profit & Loss Account

Profit and Loss Account of ....

For the year ended on..........

Dr. Particulars	₹ Amount	Particulars	₹ Amount Cr.
To Gross loss c/d	***	By Gross Profit b/d	***
To Administrative expenses		By Dividend received	***
Salaries	***	By Interest received	***
Rent rates, and taxes	***	By Rent received	***
Printing & Stationery	***	By Discount received	***
Postage & Telegram	***	By Commission received	***
Telephone Charges	***	By Bad Debts recovered	***
Legal Charges	***	By Apprenticeship premium	***
Insurance	***	By Income from investments	***
Audit fees	***	By Sundry revenue receipts	***
Director's fees	***	By Net Loss transferred to	
General expenses	***	Capital Account	***
To Selling and Distribution Expenses			
Advertising	***		
Commission paid	***		
Bad Debts	***		
Provision for doubtful debts	***		
Carriage & Freight outward	***		
Packing expenses	***		
Sundry trade expenses	***		
Travelling expenses	***		
Distribution expenses	***		
Export duty	***		
To Depreciation & Maintenance			
Depreciation	***		
Repairs	***		
To Financial expenses			
Interest on borrowing	***		
Discount allowed	***		
To Abnormal loss			
Loss by fire	***		
Loss on sale of assets	***		
To Net Profit transferred to			
Capital account	***		

Example: From the following balances, taken from the Trial balance of Mr. Suresh, prepare the Trading and Profit and Loss Account for the year ending 31st Dec., 2015

Particulars	***Dr .***	***Cr.***
Stock on 1st Jan, 2015	*2,000*	
Purchases and Sales	*20,000*	*30,000*
Return	*2,000*	*1,000*
Carriage Inward	*1,000*	
Cartage Inward	*1,000*	
Rent	*1,000*	
Interest received		*2,000*
Salaries	*2,000*	
General expenses	*1,000*	
Discount	*1,000*	*500*
Insurance	*500*	

The closing stock on 31st Dec. 2012 is Rs. 5,000

Solution:

Trading and Profit & Loss Accounts

For the year ending 31st Dec., 2012

Particulars	***Amount [Rs.]***		***Particular***	***Amount [Rs.]***
To Opening stock	*2,000*		*By Sales 30,000*	
To Purchases 20,000				*28,000*
	19,000		*Less: Returns 2,000*	*5,000*
Less: Returns 1,000	*1,000*			
	1,000		*By Closing stock*	
To Carriage Inward	*10,000*			
To Cartage Inward				
	33,000			*33,000*
To Gross Profit c/d				
	1,000			*10,000*
Total:			*Total:*	
	2,000			*2,000*
To Rent			*By Gross Profit b/d*	
	1,000			*500*
To Salaries			*By Interest*	
	1,000			
To General expenses			*By Discount*	
	500			
To Discount				
	8,000			
To Insurance				
	12,500			*12,500*
To Net Profit taken to Capital account				
			Total:	
Total:				

6.4 CLOSING ENTRIES

Closing entries are entries passed at the end of the accounting year to close different accounts. These entries are passed to close the accounts relating to incomes, expenses, gains and losses. In other words these entries are passed to close the different accounts which pertain to trading and profit & loss account. The accounts relating to assets and liabilities are not closed but they are carried forward to the next year. Hence, no closing entries are to be passed regarding those accounts which relate to the balance sheet. The principle of passing closing entry is very simple. In case an account shows a debit balance, it has to be credited in order to close it. For example, if the Purchase Account is to be closed, the Purchase Account will have to be credited so that it may be closed because it has a debit balance. The trading account will have to be credited.

The closing entries are passed in the Journal Proper. The different closing entries to be passed by the accountant for preparing a Trading account are being explained below:

1. Trading account Dr.

   To stock account [opening]

   To purchases account

   To sales return account

   To carriage account

   To customs duty account

2. Sales account Dr.

   Purchase return account Dr.

   Stock account [closing] Dr.

   To Trading account

In case the total of the credit side of the Trading account is greater than the total of the debit side of the Trading account, the difference is known as Gross Profit. In a reverse case it will be a Gross Loss. Gross Profit or Gross Loss disclosed by the Trading account is transferred to the Profit & Loss account.

6.5 BALANCE SHEET

Balance sheet is a snapshot of a company's financial standing at an instant in time. It shows the company's financial position, what it owes [liabilities and net worth]. The 'bottom line' of a balance sheet must always balance [i.e. assets= liabilities + net worth]. The individual elements of a balance sheet change from day to day and reflect the activities of the company. The balance sheet is not an account but only a statement containing the assets and liabilities of a business on a particular date. It has two sides. On the left hand side, the 'liabilities' of the business are shown and on the right hand side the 'assets'.

According to Palmer, 'The balance sheet is a statement at a given date showing on one side the trader's property and possessions and on the other side his liabilities'. According to the American Institute of Certified Public Accountants, 'balance sheet is a list of balances in the asset and liability accounts, which depicts the position of asset and liabilities of a specific business at a specific point of time'. The liabilities and the net worth on the balance sheet represent the company's sources of funds. They are composed of the creditors and investors who have provided cash or its equivalent to the company in the past. Assets on the other hand, represent the company's use of funds. The company uses cash or other funds provided by the creditors/investor to acquire assets. Assets include all the things of value that are owned or due to the business.

Important Points Regarding Balance Sheet

(1) Liabilities: These denote claims against the assets of a firm whether those of owners of the business or of the creditors. According to American Accounting Association, Liabilities are claims of the creditors against the enterprise arising out of past activities that are to be satisfied by the disbursement or utilization of corporate resources. Liabilities can be classified into two categories:

a. **Current liabilities:** The term is used for such liabilities which are payable within a year from the date of the balance sheet either out of existing current assets or by creation of new current liabilities. e.g. accounts payable, outstanding expenses, bank overdraft, short term loans, advance payments, etc.

b. **Fixed liabilities:** All liabilities other than current liabilities come within this category. In other words, these are liabilities which do not become due for payment in one year and which do not require current assets for their payment.

(2) Assets: These denote the resources acquired by the business from the funds made available either by the owners of the business or others. They thus, include all rights or properties which business owns. Cash, investments, bills receivable, debtors, stock of raw materials, work in progress and finished goods, land, buildings, machinery, trade, marks, patent rights etc. are some examples of assets. Assets may be classified into the following categories:

a. **Current assets,** which are acquired with the intention of converting them into cash during the normal business operations of the enterprise. e.g. cash, bank balances, stock of raw materials, work in progress, and finished goods, etc.

b. **Liquid assets,** which are immediately convertible into cash without much loss. They are a part of current asset,

c. **Fixed assets,** which are acquired for relatively long periods for carrying on the business of the enterprise. they are not meant for resale. e.g. land , building, machinery, furniture etc.

d. **Intangible assets,** which can not be seen and touched. Goodwill, patent, trade marks etc.

e. **Fictitious assets,** these are assets not represented by tangible possession or property. Example of such assets are Preliminary expenses incurred for establishing a business.

Format of Balance Sheet

The assets and liabilities may be shown in any of the orders:

Liquidity order: In case a concern adopts the liquidity order, the assets which are more readily convertible into cash come first and those which cannot be so readily converted come next, and so on. Similarly, those liabilities which are payable on a priority basis come first, and those payable later come next, and so on.

Balance sheet

As on ....[as per liquidity order]

Liabilities	*[Rs.]*	**Assets**	*[Rs.]*
Bank Over draft	***	Cash in hand	***
Outstanding expenses	***	Cash at bank	***
Bills payable	***	Prepaid expenses	***
Sundry creditors	***	Bills receivable	***
Long term loans	***	Sundry creditors	***
Capital	***	Closing stock;	
		Raw materials	***
		Work in progress	***
		Finished goods	***
		Furniture	***
		Plant & Machinery	***
		Building	***
		Land	***
		Goodwill	***

Permanency Order: Assets which are more permanent come first, those which are less permanent come next, and so on. Similarly, liabilities which are more permanent come first and which are less permanent come next and so on.

Balance sheet

As on ....[as per permanency order]

Liabilities	*[Rs.]*	**Assets**	*[Rs.]*
Capital	***	Goodwill	***
Long term loans	***	Land	***
Sundry creditors	***	Building	***
Bills payable	***	Plant & Machinery	***
Outstanding expenses	***	Furniture	***
Bank overdraft	***	Raw materials	***
	***	Work in Progress	***
		Finished Goods	***
		Prepaid expenses	***
		Sundry debtors	***
		Bills receivable	***
		Cash at bank	***
		Cash in hand	***
		Closing stock:	

Example: From the following ledger balances extracted from the books of M/s Agarwal & Bros., prepare Trading and Profit & Loss Accounts and Balance Sheet.

Particulars	*[Rs.]*	***Particulars***	*[Rs.]*
Capital	*1,00,000*	*Return inwards*	*10,000*
Overdraft	*16,800*	*Discount [cr.]*	*1,600*
Furniture	*10,400*	*Taxes and Insurance*	*8,000*
Business premises	*80,000*	*General expenses*	*16,000*
Creditors	*55,200*	*Salaries*	*36,000*
Opening stock	*88,000*	*Commission allowed*	*8,800*
Debtors	*72,000*	*Carriage on purchases*	*7,200*
Rent from tenants	*4,000*	*Bad debts*	*3,200*
Purchases	*4,40,000*	*Closing stock*	*80,240*
Sales	*6,02,000*		

Solution :

Trading and Profit & Loss Accounts

M/s Agarwal & Bros.

Particulars	*[Rs.]*	***Particulars***	*[Rs.]*
To Opening stock	*88,000*	*By Sales 6, 02,000*	
To Purchases	*4,40,000*		*5,92,000*
To Carriage on Purchases	*7,200*	*Less: Returns inward 10,000*	*80,240*
	1,37,040		
To Gross Profit c/d	*6,72,240*	*By Closing Stock*	*6,72,240*
Total:	*36,000*		*1,37,040*
To Salaries	*8,000*		*4,000*
To Taxes and insurance	*16,,000*		*1,600*
To General expenses	*8,800*	*By Gross Profit b/d*	
To Commission allowed	*3,200*		
	70,640	*By Rent from tenants*	
To Bad debts	*1,42,640*	*By discount*	*1,42,640*
To Net Profit taken to capital account			
Total:		*Total*	

Balance sheet of M/s Agarwal & Bros.

Liabilities	*[Rs.]*		***Assets***	*[Rs.]*
Capital 1,00,000			*Business premises*	*80,000*
	1,70,640		*Furniture*	*10,400*
Add : Net Profit 70, 640	*16,800*		*Debtors*	*72,000*
Overdraft	*55,200*		*Closing stock*	*80, 240*
Creditors	*2,42,640*		*Total:*	*2,42,640*
Total:				

6.6 VERTICAL PRESENTATION OF FINAL ACCOUNTS

The financial statements have been presented in 'T' form, which is also called the Account form, horizontal or traditional form. Another form of presentation, which is quite simple and easy to understand is known as 'vertical' form of presentation which is also called Report form, Columnar Form, or Running Form. It is a system of presentation of information in trading, profit and loss account and balance sheet in which items relating to income or gains and expenses or losses and assets and liabilities are placed one after another, instead of side by side, in such a manner that significant information relating to cost of goods sold, gross profit, net profit, current assets, current liabilities, fixed assets, proprietor's funds etc. are revealed to the readers at a galance.

Following are the proforma of Trading and Profit & Loss Accounts and Balance Sheet in the vertical form:

Trading and Profit & Loss Accounts

For the year ended ....

Items	*[Rs.]*	*[Rs.]*
SALES	……..	
Less: Return	……..	
NET SALES		
		....
Less: Cost of goods sold		
Opening stock	....	
Add: Purchases Less: Returns	....	
Add: Direct Expenses e.g. Carriage inwards	....	
Less: Closing stock	....	
GROSS PROFIT		....
Add : Interest, rent, commission, profit on sale of assets, etc.	……..	
		....
	....	....
Less : Indirect expenses, e.g. general administration, selling expenses, loss on sale of assets		
		………..
NET PROFIT		……… …

Name of the Firm

BALANCE SHEET

As on ....

Items	*[Rs.]*	*[Rs.]*
FIXED ASSETS		
Goodwill	....	
Land and Building Less Depreciation	....	
Plant and Machinery Less Depreciation	....	
Furniture Less Depreciation	....	
Office equipments Less Depreciation	....	
Motor vehicles Less Depreciation	....	
		....
CURRENT ASSETS		
Stores and spare parts	....	
Stock–in –trade [Closing stock]	....	
Investments – short term	....	
Sundry debtors Less Provision for bad debts	....	
Unexpected payments	....	
Bills receivable	....	
Accrued income	....	
Cash at bank	....	
Cash in hand	....	
LESS CURRENT LIABILITIES		
Sundry creditors		
Bills payable		

Outstanding liabilities for expenses		....
	....	....
NET WORKING CAPITAL		
Financed by :		
CAPITAL:		
Balance		
Add Net Profit	....	
Less Drawings	....	
Loans		…………
		…….....
		....

6.7 MANUFACTURING ACCOUNTS

We have explained the preparation of the Trading and Profit & Loss Account from the point of view of a trade, i.e. a person who purchases and sell goods. However, a person may manufacture goods by himself for selling them at a profit. In case of such a person i.e. a manufacturer, it will be necessary to ascertain the cost of manufacturing the goods. In his case, therefore, the profit or loss made by him will be ascertained by preparing the following three accounts:

1. **Manufacturing account**: This account gives the cost of the goods manufactured by a manufacturer during a particular period.

2. **Trading account**: This account gives information about the gross profit or loss made by a manufacturer in selling the manufactured goods. In case a manufacturer also functions as a trader, i.e. besides manufacturing he is selling goods of his own and he also purchases and sells goods of others, he will be a manufacturer, cum-trader. In such a case, his trading account will disclose not only the profit made by him on selling his manufactured goods, but also the profit made by him in selling the goods purchased by him from others.

3. **Profit & Loss Account:** This account gives the overall profit made or loss suffered by the manufacturer or manufacturer-cum-trader during a particular period.

Important Points Regarding Manufacturing Account:

1. **Stock:** In case of a manufacturer, there can be stocks of three types

    a. **Stock of raw materials:** These include stock of raw materials or finished components which might have been purchased by the manufacturer for using them in the products manufactured by him but still lying unsold.

    b. **Stock of work-in-process:** This is also termed as stock of work-in-progress. It includes goods in semi finished form.

    c. **Stock of finished goods:** It includes the stock of those goods which have been completely processed and are lying unsold at the end of a period with the manufacturer. It also includes stock of those finished goods which might have been purchased by a manufacturer-cum-trader from outside parties, but still lying unsold with him at the end of the accounting period

2. **Raw material consumed:** It is customary to show in the Manufacturing Account, the value of raw materials consumed for manufacturing goods during a particular period.

3. **Carriage inwards etc.:** The expenses incurred for bringing the raw materials to the factory or the octroi or customs duty paid by the manufacturer on the raw materials purchased or imported by him will also be charged to manufacturing account

4. **Factory overheads:** The te rm 'overheads' includes indirect material, indirect labour, and indirect expenses. The term 'factory overheads', therefore, stands for all factory indirect material, indirect labour, and indirect expenses.

5. **Cost of Production:** The manufacturing account gives the cost of manufacturing the goods during a particular period. This is computed by deducting from the total of the debit side of the manufacturing account, the total of the various items appearing on the credit side of the manufacturing account.

6. **Sale of scrap:** In manufacturing operations, certain scrap is unavoidable. It may or may not have any sales value. In order to calculate the true cost of manufacturing the goods, it is necessary that the money realised on account of sale of scrap should be considered. The amount of scrap is, therefore, credited to the manufacturing account.

Format of Manufacturing Account

Manufacturing Account

For the year ending ....

Particulars	[Rs.]	Particulars	[Rs.]
To - Work in-process [opening]	......	By Work-in-process [closing]	.....
To Raw materials consumed:		By Sale of scrap	......
Opening stock	......	By Cost of production of finished goods during the period transferred to the Trading Account	......
add: Purchases of raw material	......		
less : Closing stock of raw materials	......		
To Direct or Productive wages	......		
To Factory overheads:	......		
To Power and fuel	......		
To Repairs of plant	......		
To Depreciation on plant			
To Factory rent			
Total:		Total:	......

Example: From the following details, prepare a manufacturing and a trading account for the year ending 31st Dec., 2015:

	Rs.
Stock on 1st Jan 2015	
Raw Materials	*10,000*
Work in Progress	*5,000*
Finished goods	*20,000*
Stock on 31st Dec 2015	
Raw Materials	*5,000*
Work in Progress	*15,000*
Finished goods	*30,000*
Purchase of Raw Materials	*50,000*
Direct wages	*10,000*
Carriage charges on purchase of raw materials	*5,000*
Factory power	*5,000*
Depreciation on factory machine	*5,000*
Purchase of Finished goods	*30,000*
Cartage paid on finished goods purchased	*2,000*

Solution:

Manufacturing Account

For the year ending 31.12.2015

Particulars	*[Rs.]*	***Particulars***	*[Rs.]*
To Work-in-progress on 1.1.2015	*5,000*	*By Work-in-process on 31.12.2009*	*15,000*
To raw materials consumed:		*By Cost of production transferred to the Trading Account*	*70,000*
Stock on 1.1.2009			
10,000			
add: Purchases 50,000	*55,000*		
	10,000		
60,000	*5,000*		
Less : Closing stock 5,000	*5,000*		
	5,000		
To Direct wages	*85,000*		*85,000*
To Carriage Charges			
To Factory Power		*Total:*	
To Depreciation on Factory machines			
Total:			

Trading Account

For the year ending 31.12.2015

Particulars	*[Rs.]*	***Particulars***	*[Rs.]*
To Stock of finished doods on 1.1.2015	*20,000*	*By Stock of Finished goods on 31.12.2015*	*30,000*
		By Sale of Finished Goods	*1,00,000*
To Cost of production of finished goods transferred from Manufacturing Account	*70,000*		
	30,000		
To Purchases of finished goods			
	2,000		
To Cartage on finished goods purchased	*8,000*		
To Gross Profit transferred to Profit & loss Account	*1,30,000*	*Total:*	*1,30,000*
Total:			

6.8 SUMMARY

Trial balance is the first step towards preparation of Trading account, Profit and Loss Account and Balance Sheet, which are prepared on accrual basis. Trading account is prepared to determine the gross profit arising out of trading operations for a given period. Profit and loss account is prepared in order to determine the income earned or loss incurred during the accounting period. All the indirect expenses and losses are debited to it and all incomes and gains, besides the gross profit, are credited to profit and loss account.

A balance sheet is a statement of assets and liabilities of a business enterprise on a particular date. The balance sheet discloses the financial position of a business on a particular date. When assets and liabilities are arranged in the order of permanence, it is known as on fixity basis, and when arranged in terms of liquidity, it is known as on liquidity order basis.

Closing entries are journal entries required for transferring all accounts relating to expenses and gains to trading and profit and loss accounts.

Final accounts or financial statements are trading and profit and loss accounts and balance sheet. They are the end product of the financial accounting process. In order to prepare the financial statements from the Trial balance, additional information, if any, has to be processed and adjusting entries are made about different items. A balance sheet is a statement only and it has no debit and credit side. It is prepared on a particular date and is true only for that particular date. It is called balance sheet because it is actually a sheet of balances of ledger accounts which have not been closed by a transfer to Trading and Profit & loss account.

6.9 REFERENCES

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SELF ASSESMENT QUESTIONS:

1. What are final accounts? What purpose do they serve?
2. Describe briefly Profit and Loss Account and Trading Account.
3. Write short note on
   a. Closing Entries.
   b. Manufacturing Account.
   c. Trial Balance.
4. Distinguish between Trial Balance and Balance Sheet.
5. From the following particulars prepare Manufacturing Account, Trading Account and Profit and Loss Account:

	Rs.
Purchases of raw materials	13,195
Return Inward	70
Stock on 31.12.2015	
Raw materials	1,210
Work-in-progress	1,000
Finished goods	1,370
Productive wages	2,000
Factory expenses	1,840
General Office expenses	300
Salaries	600
Distribution expenses	100
Selling expenses	700
Purchasing expenses	600
Export duty	300
Import duty	200
Interest on bank loan	600
Stock on 1.1.2015	
Raw material	400
Work-in-progress	300
Finished goods	410
Sales	19,500

Return outward	85
Carriage outward	105
Carriage inward	100
Cash discount [allowed]	10
Sale of scrap	20
Depreciation of machinery	500
Repairs of machinery	100
Depreciation of office furniture	40

[Ans; Gross Profit Rs. 3,470, Net Profit Rs. 7,150]

UNIT-07 FINAL ACCOUNTS-II

Objectives :

After going through this unit, you must be able to understand:

- Need for adjustment;
- Treatment of adjustments in final accounts;
- Impact of interest on capital , loan etc.;
- Meaning and provision of bad debts.

Structure :

7.1 Need for adjustments

7.2 Treatment of adjustments in final accounts

7.2.1 Closing stock

7.2.2 Outstanding expenses

7.2.3 Prepaid expenses

7.2.4 Accrued income

7.2.5 Received in advance

7.2.6 Depreciation

7.3 Interest on capital

7.4 Interest on drawings

7.5 Interest of loan

7.6 Bad debt

7.7 Provision for bad debts

7.8 Provision for discount on debtors

7.9 Provision for discount on creditors

7.10 Manager's commission

7.11 Abnormal loss of stock

7.1 NEED FOR ADJUSTMENTS

In the preparation of Final Accounts, we have presumed that the accountant has taken into consideration all important facts before closing the books of accounts and preparing the Final Accounts. However, it may not always happen. The accountant may come to know of certain adjustments to be made in the books of accounts to give a true picture of the state of affairs of the business after closing the books of accounts and preparing the trial balance.

7.2 TREATMENT OF ADJUSTMENTS IN FINAL ACCOUNTS

7.2.1 CLOSING STOCK

Closing stock is the stock of goods remaining unsold with the trader at the end of the accounting period. This should be brought into account to get accurate result of the trading. Generally, closing stock does not appear in trial balance. Therefore, by passing an adjustment entry, it is incorporated in final accounts.

Adjustment entry at the end of the year:

Closing stock A/c Dr.

To Trading A/c

[Value of closing stock brought into account]

Stock at the end appears in the balance sheet and its balance at the end of the accounting period is carried forward to the next year. It comes as opening stock in the trial balance of the next year, from where it is transferred to the trading account on the debit side. Some times, the value of the closing stock at the end of the accounting year is given in the trial balance. In such a case, the closing stock will be shown only in the balance sheet. The reason is that the closing stock has already been taken into account while computing the cost of the goods sold.

Example : Following are the extracts from the Trial Balance of a firm

Trial Balance

For the year ending on………………..

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Opening Stock	*20,000*	
Purchases	*50,000*	
Sales		*90,000*

Additional information:

1. *Stock at the end of the year is Rs. 20,000*

You are required to pass the necessary adjustment entries and show how the above items will appear in the Final Accounts.

Solution: In this case, the closing stock has been given in the adjustments. Therefore this item appears in the final accounts as follows:

TRADING ACCOUNT for the year ended on………..

Particulars	*Amount [Rs.]*	*Particulars*	*Amount [Rs.]*
To Opening Stock	*20,000*	*By Sales*	*90,000*
To Purchases	*50,000*	*By Closing stock*	*20,000*
To Gross profit c/d	*40,000*		
Total:	*1,10,000*	*Total:*	*1,10,000*

BALANCE SHEET

Liabilities	*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
		Closing stock	*20,000*

7.2.2 OUTSTANDING EXPENSES

Outstanding expenses refer to those expenses which have become due during the accounting period for which the Final Accounts have been prepared but have not yet been paid. This happens particularly regarding those expenses which accrue from day to day business but which are recorded only when they are paid. Examples of such expenses are rent, salaries, interest, etc. Some of these expenses may have remained unpaid at the end of the accounting period and, therefore, no entry might have been passed in the books of the accounts. For example, if the salary for the month of December has not been paid, no entry might have been passed in the books for the salary remaining outstanding on 31st December. However, in order to ascertain the true profit or loss made during the accounting year ending 31st December, it is necessary that such outstanding salaries are taken into account. The following journal entry will be passed in case of such outstanding expenses:

Salaries A/c

Dr.

To Outstanding salaries A/c

Salaries account is a nominal account and, therefore, it should be charged to the Profit & Loss Account, while the Outstanding salaries account is a personal account representing the persons to whom the salary has to be paid. It is, therefore, shown in the Balance sheet on the liabilities side.

Example : Following are the extracts from the Trial Balance of a firm as on 31st December, 2015

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Salaries A/c *Rent A/c*	*10,000* *5,000*	

Additional information:

2. *Salary for the month of December Rs. 2,000 has not yet been paid*
3. *Rent amounting to Rs. 1,000 is still outstanding*

You are required to pass the necessary adjustment entries and show how the above items will appear in the Final Accounts.

Solution :

JOURNAL PROPER

Date	*Particulars*	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
	Salaries A/c *Dr.* *To Outstanding salaries A/c* *[Being salaries due but not paid]*	*2,000*	 *2,000*
	Rent A/c *Dr.* *To Outstanding Rent A/c* *[Being rent due but not paid]*	*1,000*	 *1,000*

PROFIT & LOSS ACCOUNT

For year ended on 31st Dec. 2015

Particulars	*Amount [Rs.]*	*Particulars*	*Amount [Rs.]*
To Salaries 10,000 *[as given in the Trial Balance]* *Add: Outstanding* *Salaries 2,000*	*12,000*		
To Rent 5,000 *[as given in the Trial Balance]* *Add: Outstanding* *Rent 1,000*	*6,000*		

BALANCE SHEET

As on 31st Dec., 2015

Liabilities	*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
Outstanding expenses *Outstanding salaries 2,000* *Outstanding Rent 1,000*	*3,000*		

7.2.3 PREPAID EXPENSES

Prepaid expenses are those expenses which have been paid in advance. In other words, these are the expenses which have been paid during the accounting period for which the Final Accounts are being prepared but they relate to the next period. For example, during the accounting year ending on 31st December, 2015, insurance premium for the year ending 31st March, 2016 might have been paid. In means insurance for three months has been paid in advance. In order to ascertain true profit or loss only expenses relating to the accounting period should be charged to the Profit and Loss Account. Any expenses paid in advance should be carried forward to the next year. The following journal entry is passed for an expense paid in advance:

Prepaid Expense A/c Dr.

To Expense A/c

Expense account is a nominal account and, therefore, the amount should be credited to the Profit & Loss Account preferably the amounts should be deducted from the relevant Expense Account in respect of which the payment has been made in advance. Prepaid expense account is a Personal Account, it represents the account of the person to whom payment has been made in advance. It is, therefore, shown in the balance sheet on the assets side.

Example : Following are the extracts from the Trial Balance of a firm as on 31st December, 2015;

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Insurance *Rent*	*8,000* *4,000*	

Additional information:

1. *Insurance premium has been paid in advance amounting Rs. 1,000 for the next year.*
2. *Rent amounting to Rs. 500 has been paid for the next year*

You are required to pass the necessary adjustment entries and show how the above items will appear in the Final Accounts.

Solution:

JOURNAL PROPER

Date	*Particulars*	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
	Prepaid Insurance A/c Dr. *To insurance A/c* *[Being insurance premium paid in advance]*	*1,000*	*1,000*
	Prepaid Rent A/c Dr. *To Rent A/c* *[Being rent paid in advance]*	*500*	*500*

PROFIT & LOSS ACCOUNT

For the period ended on 31st Dec. 2015

Particulars		*Amount [Rs.]*	*Particulars*	*Amount [Rs.]*
To Insurance	*8,000*			
Less: Prepaid	*1,000*	*7,000*		
To Rent	*4,000*			
Less: Prepaid	*500*	*3,500*		

BALANCE SHEET

As on 31st Dec. 2015

Liabilities	*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
		Prepaid insurance	*1,000*
		Prepaid rent	*500*

7.2.4 ACCRUED INCOME AND OUTSTANDING INCOME

Accrued income means income which has been earned by the business during the accounting year but which has not been received. Adjusting entry of such income is shown below:

Accrued income A/c   Dr.

To income A/c

Example : Following are the extracts from the Trial Balance of a firm as on 31st December, 2015

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
6% Loan	*20,000*	
Investments in 6% Debentures of 'B' Ltd.	*30,000*	
[interest payable on 31st March and 30th Sept]		
Interest on loan received upto 31st Oct, 2015		*1,000*
Interest on investments		*900*

You are required to pass the necessary adjusting entries and show how the above items will appear in the Final Accounts.

Solution: in the above case, interest on loan for a period of two months is still outstanding. The amount of such interest is Rs. 200. In case of debentures, interest for three months has been earned by the business. The amount of accrued interest, therefore, comes to Rs. 450. The following adjusting entries will, therefore, be passed in the journal proper:

JOURNAL PROPER

Date	*Particulars*	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
	Outstanding interest A/c Dr. *To interest A/c* *[Being interest on loan due but not received]*	*200*	*200*
	Accrued interest A/c Dr. *To interest on investments A/c* *[being interest earned, but not received]*	*450*	*450*

Outstanding interest account and interest accrued account are personal accounts. They represent the accounts of the persons from whom the interest has to be received. They will, therefore, be shown on the asset side in the balance sheet. Interest account is a nominal account, and it has been credited. The amount of the interest will be added to the amount of interest already appearing in the Trial Balance.

PROFIT & LOSS ACCOUNT

For the year ended on 31st Dec. 2015

Particulars	*Amount [Rs.]*	*Particulars*		*Amount [Rs.]*
		By Interest on loan	*1,000*	
		Add :outstanding interest	*200*	*1,200*
		By Interest on investments	*900*	
		Add : Accrued Interesst	*450*	*1,350*

BALANCE SHEET

As on 31st Dec. 2015

Liabilities	*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
		Outstanding interest A/c	*200*
		Accrued interest A/c	*450*

7.2.5 INCOME RECEIVED IN ADVANCE

Income received in advance means income which has been received by the business before it being earned by the business. This includes certain prepayments which the business may receive during the course of the accounting year. In order to ascertain the true profit or loss, it is necessary that such income is not taken into account while preparing the Profit & Loss Account for the year. The following adjustment entry is passed for such income:

Income A/c Dr.

To Income received in advance A/c

Example: Following are the extracts from the Trial Balance of a firm as on 31st December, 2015

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Rent received for 12 months ending 31^{s}, March, 2016		*1,200*
Interest on loan		*2,000*

Additional information: interest on loan has been received in advance to the extent of Rs. 500

You are required to pass the necessary adjusting entries and show how the above items will appear in the Final Accounts.

Solution:

JOURNAL PROPER

Date	*Particulars*	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
	Rent A/c Dr. *To Rent Received in advance A/c* *[Being rent received in advance for three months]*	*300*	*300*
	Interest A/c Dr. *To Interest received in advance A/c* *[Being interest received in advance]*	*500*	*500*

PROFIT & LOSS ACCOUNT

For the year ended on 31st Dec. 2015

Particulars	*Amount [Rs.]*	*Particulars*		*Amount [Rs.]*
		By Interest	*2,000*	
		Less :Received in advance	*500*	*1,500*
		By Rent	*1,200*	
		Less: Received in advance	*300*	*900*

BALANCE SHEET

Liabilities	*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
Rent received in advance *Interest received in advance*	*300* *500*		

7.2.6 DEPRECIATION

Depreciation denotes decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. In order to ascertain, the true profit for the business, it is necessary that depreciation is charged on the fixed assets of the business. The following entry will be passed for depreciation

Depreciation A/c Dr.

To Fixed Asset A/c

Example : Following are the extracts from the Trial Balance of a firm as on 31st December, 2015:

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Plant	*30,000*	
Building	*50,000*	

Additional information: 1. Charge depreciation on plant @ 10% per annum

2. Charge depreciation on building @ 5% per annum

You are required to pass the necessary adjusting entries and show how the above items will appear in the Final Accounts.

Solution:

JOURNAL PROPER

Date	*Particulars*	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*

	Depreciation A/c *To Plant A/c* *To Building A/c* *[Being depreciation charged on Plant and Building]*	*5,500*	 *3,000* *2,500*

PROFIT & LOSS ACCOUNT

For the year ended on 31st Dec. 2015

Particulars	*Amount [Rs.]*	*Particulars*	*Amount [Rs.]*
To Depreciation *Plant 3,000* *Building 2,500*	 *5,500*		

BALANCE SHEET

As on 31st Dec. 2015

Liabilities	*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
		Plant 30,000 *Less: Depreciation 3,000* *Building 50,000* *Less: Depreciatiion 2,500*	 *27,000* *47,500*

7.3 INTEREST ON CAPITAL

Funds provided by the proprietor to run the business is termed as Capital. In order to determine the true profit made by the business, it is necessary that the profit should be determined after deducting interest on such funds, which the proprietor could have earned otherwise. The entry for interest on proprietor's funds [or capital] is passed as follows

Interest on capital A/c Dr.

To Capital A/c

Interest on capital is allowed on the balance in the capital account in the beginning of the accounting year. However, in case the proprietor has introduced further capital during the course of the accounting year, interest on such capital will also be allowed from the date on which such further capital was introduced till the end of the accounting period.

7.4 INTEREST ON DRAWINGS

Drawings denote the money withdrawn by the proprietor from the business for his personal use. It is a usual practice to charge interest on drawings in case interest is allowed to the proprietor on his capital the following journal entry is passed for interest on drawings

Capital A/c Dr.

To Interest on drawings A/c

Example : Following are the extracts from the Trial Balance of a firm as on 31st December, 2015

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Capital Account		
A's Capital		*30,000*
B's Capital		*20,000*
Drawings:		
A	*6,000*	
B	*3,000*	

Additional information:

1. *Interest on capital is to be allowed to the partners @ 10% p.a. on the opening balances standing to the credit of their capital accounts*
2. *Interest on drawings is to be charged @ 12% p.a.*

You are required to pass the necessary adjusting entries and show how the above items will appear in the Final Accounts. You may assume that the drawings were made evenly throughout the year on 15th of each month

Solution:

JOURNAL PROPER

Date	*Particulars*	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
	Interest on capital A/c Dr. *To A's Capital A/c* *To B's Capital A/c* *[Being Interest on capital @ 10% p.a.]*	*5,000*	 *3,000* *2,000*
	A's Capital A/c Dr. *B's Capital A/c* *To Interest on drawing A/c* *[Being interest on drawing charged for 6 months @ 12% p.a.on the total amount]*	*360* *180*	 *540*

PROFIT & LOSS ACCOUNT

For the year ended on 31st Dec. 2015

Particulars		*Amount [Rs.]*	*Particulars*		*Amount [Rs.]*
To Interest on capital			*By interest on drawings*		
A	*3,000*		*A*	*360*	
B	*2,000*	*5,000*	*B*	*180*	*540*

BALANCE SHEET

Liabilities		*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
Capital Accounts:				
A's Capital A/c	*30,000*			
Add: Interest on capital	*3,000*			
	33,000			
Less: Drawings	*6,000*			
	27,000			
Less: Interest on drawings	*360*	*26,640*		
B's Capital A/c	*20,000*			
Add: Interest on capital	*2,000*			
	22,000			
Less: Drawings	*3,000*			
	19,000			
Less: Interest on drawings	*180*	*18,820*		

7.5 INTEREST OF LOAN

If the trial balance includes loan account [Cr.] or deposit account [Dr.] carrying certain rate of interest, then it is essential to calculate interest at the rate mentioned. If the interest account does not appear then the complete interest is treated as outstanding. But if it appears then it should be compared with the amount arrived at after the calculation. The difference between the two figures is treated as interest paid or outstanding. This should be brought into account by making adjustment entry.

Example: Make adjustments from the information given below:

	Dr.	*Cr.*
Loan @15% p.a.		*Rs. 50,000*
Interest on loan	*Rs. 5,625*	
Deposit @14% p.a.	*40,000*	
Interest on deposits		*4,200*

Additional information

1. *Interest on loan outstanding is Rs. 1,875*
2. *Interest on deposits has accrued Rs. 1,400*

You are required to pass the necessary adjusting entries and show how the above items will appear in the Final Accounts.

Solution:

PROFIT & LOSS ACCOUNT

Particulars	*Amount [Rs.]*	*Particulars*	*Amount [Rs.]*
To Interest on loan 5,625 *Add : outstanding 1,875*	*7,500*	*By interest on deposits 4,200* *Add : Accrued 1,400*	*5,600*

BALANCE SHEET

Liabilities	*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
Loan 50,000 *Add :interest Outstanding* *1,875*	*51,875*	*Deposits 40,000* *Add :Interest accrued 1,400*	*41,400*

7.6 BAD DEBT

Credit sales have become a must these days and bad debts occur when there are credit sales. Bad debt is a loss to the business and a gain to the debtors. The following journal entry should be passed in the event of a debt becoming bad

Bad Debts A/c Dr.

To Debtor's Personal A/c

7.6.1 PROVISION FOR BAD DEBTS

In accounting we observe the 'convention of conservatism' while recording business transactions. This means that we make provision for feared losses but we do not take credit for expected profits. A firm therefore, makes 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 the same accounting year with such likely bad debts in which the sales have been made, since the profit on such sales has been considered in the year in which the sales have been made. The following journal entry is passed for creating a provision for bad debts

Profit & Loss A/c Dr.

To Provision for Bad Debts

The provision for bad debts is charged to the Profit & Loss Account and is deducted from debtors in the balance sheet.

The provision for bad debts created at the end of the accounting year is carried forward to the next year and the bad debts occurring during the course of the next year are met out of this provision. At the end of the next year, suitable adjusting entry is passed for keeping the provision for doubtful debts at an appropriate amount to be carried forward.

Example: Following are the extracts from the Trial Balance of a firm as on 31st December, 2015:

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Sundry debtors	*30,000*	
Bad debts	*5,000*	

Additional information:

1. *After preparing the Trial Balance, it is learnt that a debtor Ramesh has become insolvent and therefore, the entire amount of Rs. 3,000 due from him was irrecoverable*
2. *Create 10% provision for bad and doubtful debts.*

You are required to pass the necessary adjusting entries and show how the above items will appear in the Final Accounts.

Solution:

JOURNAL PROPER

Date	*Particulars*	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
	Bad Debts A/c Dr. *To Ramesh A/c* *[Being amount due from Ramesh proved to be bad]*	*3,000*	 *3,000*
	Profit & Loss A/c Dr. *To Provision for bad and doubtful debts* *[Being bad debts provision created]*	*2,700*	 *2,700*

PROFIT & LOSS ACCOUNT

For the year ended on 31 Dec. 2015

Particulars	*Amount [Rs.]*	*Particulars*	*Amount [Rs.]*
To Bad Debts 5,000 *[as given in the Trial balance]* *Add: Additional bad debts 3,000* *Add: Provision for bad debts 2,700*	*10,700*		

BALANCE SHEET

As on 31st Dec. 2015

Liabilities	*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
		Sundry Debtors 30,000 *Less: Additional bad debts 3,000* *27,000* *Less: Provision for bad debts 2,700*	*24,300*

7.7 PROVISION FOR DISCOUNT ON DEBTORS

Discount may have to be allowed to the debtors on account of their making prompt payments. When discount is allowed, following journal entry is passed

Discount A/c Dr.

To Debtor's Personal A/c

At the end of the accounting year, the firm also estimates, the amount of discount which it may have to give to the debtors outstanding at the end of the accounting year in the course of the next year. This is done by creating a provision for discount on debtors. The following journal entry is passed:

Profit & Loss A/c Dr.

To Provision for Discount A/c

'Provision for discount' will be created only on good debtors. In other words, provision for discount should be made after deducting bad debts and provision for bad debts from the debtor's balances.

Example : Following are the extracts from the Trial Balance of a firm as on 31st December, 2015:

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Sundry debtors	*50,000*	
Bad debts	*3,000*	
Discount	*2,000*	

Additional information:

1. *Create a provision for doubtful debts @ 10% on debtors.*
2. *Create a provision for discount on debtors @ 5% on debtors*
3. *Additional discount given to the debtors Rs. 1,000*

You are required to pass the necessary adjusting entries and show how the above items will appear in the Final Accounts.

Solution:

JOURNAL PROPER

Date	*Particulars*	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
	Discount A/c Dr. *To Sundry Debtors A/c* *[Being discount allowed to debtors]*	*1,000*	 *1,000*
	Profit & Loss A/c Dr. *To Provision for bad and doubtful debts* *[Being provision for bad debts created at the rate of 10% on debtors of Rs. 49,000]*	*4,900*	 *4,900*
	Profit & Loss A/c *To Provision for Discount A/c* *[being provision for discount created @ 5% on debtors of Rs. 44,100 (i.e. Rs. 49,000 – Rs. 4,900)]*	*2,205*	 *2,205*

PROFIT & LOSS ACCOUNT

For the year ended on 321st Dec. 2015

Particulars		*Amount [Rs.]*	*Particulars*	*Amount [Rs.]*
To Bad Debts	*3,000*			
[as given in the Trial balance]				
Add: Provision for bad debts	*4,900*	*7,900*		
To Discount	*2,000*			
[as given in the Trial balance]				
Add : additional discount	*1,000*			
Add: Provision for discount	*2,205*	*5,205*		

BALANCE SHEET

Liabilities	*Amount [Rs.]*	*Assets*		*Amount [Rs.]*
		Debtors	*50,000*	
		Less: Additional discount	*1,000*	
			49,000	
		Less: Provision for bad debts	*4,900*	
			44,100	
		Less: Provision for Discount	*2,205*	*41,895*

7.8 PROVISION FOR DISCOUNT ON CREDITORS

A firm may like to create a reserve for discount on its creditors on a similar pattern on which a provision for discount on debtors is made. However, creating of such a reserve is against the fundamental convention of conservation. Such a reserve is usually not created. However, if this is done the accounting entries are passed on the same pattern on which the accounting entries are passed for provision for discount on debtors.

On receipt of additional discount from creditors

Sundry creditors A/c Dr.

To Discount A/c

For creating a reserve for discount on creditors

Reserve for Discount on creditors Dr.

To Profit & Loss A/c

Example : Following are the extracts from the Trial Balance of a firm as on 31st December, 2015

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Sundry Creditors		*30,000*
Discount		*1,000*
Reserve for discount on creditors	*2,000*	

Additional information:

1. *Create a reserve for discount @ 10% on creditors.*
2. *Additional discount received from creditors after closing the accounts Rs. 1,500.*

You are required to pass the necessary journal entries, prepare Reserve for Discount Account and show how the above items will appear in the Final Accounts.

Solution:

JOURNAL PROPER

Date	*Particulars*	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
	Sundry creditors A/c Dr.	*1,500*	
	To Discount A/c		*1,500*
	[Being discount received from creditors]		
	Discount A/c Dr.	*2,500*	
	To Reserve for discount on creditors		*2,500*
	[Being discount received transferred to Reserve for discount A/c]		
	Reserve for discount A/c	*3,350*	
	To Profit & Loss A/c		*3,350*
	[Being amount credited to profit and loss account for maintaining reserve for discount account at 10% on creditors]		

PROFIT & LOSS ACCOUNT

For the year ended on 31st Dec. 2015

Particulars	*Amount [Rs.]*	*Particulars*		*Amount [Rs.]*
		By Discount	*1,000*	
		[as given in the Trial balance]		
		Add : additional discount received	*1,500*	
		Add: new reserves for discount	*2,850*	
			5,350	
		Less: Old Reserve for discount	*2,000*	*3,350*

RESERVE FOR DISCOUNT ON CREDITORS ACCOUNT

Particulars	*Amount [Rs.]*	*Particulars*	*Amount [Rs.]*
To Balance b/d	*2,000*	*By Discount A/c*	*2,500*
To Profit & Loss A/c	*3,350*	*By Balance c/d*	*2,850*
Total:	*5,350*	*Total:*	*5,350*

7.9 MANAGER'S COMMISSION

In some cases, the manager of a business may be given a commission based on a fixed percentage of the net profit earned by the business. In such a case, the total net profit iscalculated and then the percentage of the commission is applied. Suppose, the net profit after taking into account all expenses except commission is Rs. 1,05,000 and the manager is to be given a commission of 5% on the net profits before charging such commission.

His commission will be Rs. 1,05,000*5/100 = Rs. 5,250

The journal entry for this commission is

Profit & Loss Account Dr.

Rs. 5,250

To Outstanding Manager's Commission Account Rs. 5,250

Outstanding Manager's Commission will be shown on the debit side of Profit & Loss Account and as a liability on the liabilities side of the balance sheet, because it is still to be paid to the manager.

7.10 ABNORMAL LOSS OF STOCK

When goods are damaged/destroyed by fire, accidents or so on , the total value of such loss should be credited to the Trading account. The entry for this is

Goods Damaged/ Lost A/c Dr.

To Trading A/c

If nothing is recoverable 0from the insurance company, the entire loss is transferred to Profit & Loss Account. The entry will be:

Profit & Loss A/c Dr.

To Goods Damaged/loss A/c

If any amount is recoverable from the insurer, then the Insurance Company account should be debited with the amount agreed to be given by them and the Profit & Loss Account should be debited only with the balance of loss. Further, the amount agreed to be given by the insurance company should be shown as an asset in the balance sheet as 'insurance claim'

7.11 DRAWINGS OF GOODS BY THE PROPRIETOR

Goods taken by the proprietor should be treated as drawings and hence, the Drawings account should be debited. The corresponding credit should be given to Purchase account, as the goods are reduced from the purchases. The adjustment entry required is :

Drawing A/c Dr.

To Purchases A/c

In the final accounts, the value of the goods taken by the proprietor should be deducted from Purchases in the trading account and the same should be added along with other drawings and deducted from capital in the balance sheet.

7.12 PREPARATION OF FINAL ACCOUNTSWITH ADJUSTMENTS

The following points should always be borne in mind in the preparation of final accounts with adjustments:

1. When an adjustment entry is passed, it affects the Trading account and Balance sheet or the Profit & Loss Account and Balance sheet or the Trading account and Profit & Loss Account. It may be stated here that an item given in the Trial balance should be taken to either the Trading account or the Balance sheet, or the Profit & Loss Account [only in any one of these]
2. Sometimes, a few adjustment items also may appear in the trial balance, e.g. outstanding expenses, accrued income, depreciation, and so on. It indicates that the adjustments with regards to these items have already

been made. Therefore, no further adjustments in the form of additions or deductions need be made. In the case of outstanding adjustment, accrued income, prepaid expenses, unearned income and so on, appearing in the trial balance, no adjustment in the form of either addition or deduction should be made in the Trading account and Profit & Loss Account. These fictitious assets/liabilities are to be shown only in the balance sheet.

3. If it is depreciation appearing in the trial balance, it should not be deducted from the concerned asset in the balance sheet, as adjustment for this has already been made. Depreciation is to be shown only in the Profit & Loss Account.

Example : Following are the extracts from the books of Raju as on 31st December, 2015

Trial Balance

As on 31st December, 2015

Particulars	*Dr. Amount [Rs.]*	*Cr. Amount [Rs.]*
Sundry debtors	*50,600*	
Sundry creditors		*10,000*
Bills receivable	*5,000*	
Plant & Machinery	*75,000*	
Purchases	*90,000*	
Capital		*70,000*
Freehold premises	*50,000*	
Salaries	*11,000*	
Wages	*14,400*	
Postage and stationery	*750*	
Carriage in	*750*	
Carriage out	*1,000*	
Bad debts	*950*	
Bad debts provision		*350*
General charges	*1,500*	
Cash at bank	*5,300*	
Cash in hand	*800*	
Bills payable		*5,000*
Reserve		*20,000*
Sales		*2.31,000*
Closing stock	*30,000*	
	3,37,050	*3,37,050*

The following adjustments are required:

1. *Raju gets a salary of Rs. 9,000 p.a.*
2. *Allow 5% interest on capital.*
3. *Bad debts provision to be adjusted to 2.5% on sundry debtors.*
4. *2.5% of the net profit to be credited to Reserve.*
5. *It was discovered in January 2015 that stock sheets as on 31st December 2014 were overcast by Rs. 1,000*

You are required to prepare Trading and Profit & Loss Account for the year ended 31st December, 2015 and a Balance sheet as at that date.

Solution:

TRADING ACCOUNT

For the year ended on 31st Dec., 2015

Particulars	Amount [Rs.]	Particulars	Amount [Rs.]
To Purchases 90,000		By Sales	2,31,700
Less: overcast stock 1,000	89,000		
To Wages	14,400		
To Carriage inward	750		
To Gross Profit	1,27,550		
Total:	2,31,700	Total:	2,31,700

PROFIT & LOSS ACCOUNT

For the year ended on 31st Dec., 2015

Particulars		Amount [Rs.]	Particulars	Amount [Rs.]
To Salaries	11,000		By Gross profit	1,27,550
Add : Outstanding	9,000	20,000		
To Postage and Stationery		750		
To Carriage out		1,000		
To Bad debts	950			
Add : New provision	1,265			
	2,215			
Less: old provision	350	1,865		
To General charges		1,500		
To Interest on capital		3,500		
To Net profit transferred to Capital A/c		98,935		
Total:		1,27,550	Total:	1,27,550

BALANCE SHEET

As on 31^{st} Dec., 2015

Liabilities	*Amount [Rs.]*	*Assets*	*Amount [Rs.]*
Capital 70,000		*Plant & Machinery*	*75,000*
Add: Interest on capital 3,500		*Freehold premises*	*50,000*
73,500		*Sundry debtors 50,600*	
Add: Net profit(98,935-2473)	*1,69,962*	*Less: Provision 1,265*	*49,335*
96,462	*10,000*	*Bills receivable*	*5,000*
Sundry creditors	*5000*	*Closing stock*	*30,000*
Bills payable		*Overstated stock, 2014*	*1,000*
Reserve 20,000	*22,473*	*Cash at bank*	*5,300*
Add: 2½% net profit 2,473	*9,000*	*Cash in hand*	*800*
Outstanding salaries	*2,16,435*		*2,16,435*
		Total:	
Total:			

7.13 ADJUSTMENTS GIVEN IN TRIAL BALANCE

There are certain items given in the Trial Balance which require adjustment. But no adjustment is given relating to such items in the footnote. This is because the items given in the Trial balance themselves will reveal such adjustment. For example, in the trial balance, the following balances are given:

8% Loan on 1 Jan, 2015 20,000

Interest on loan 800

[Paid during the year]

Actually, Rs. 1,600 interest on loan should have been paid, but only Rs. 800 has been paid and the balance Rs.800 is yet payable and outstanding. In order to bring this into account, the following adjustment entry will be passed:

Interest on loan A/c	Dr.	800	
To loan A/c			800

Therefore the items in the Trial balance are to be studied carefully to see whether any adjustment is required which is not specifically given in the problem

7.14 SUMMARY

On the closing date of any accounting year, there will be some expenses incurred during the period but not recorded at all, or some expenses paid and recorded but it's for the future period. Similarly, it may also be found that the income earned relating to the trading period is not yet received or income received during the trading period belongs to future year or the previous year. Therefore, it should be included with other expenses or income and shown in the trading or profit & loss account and balance sheet as the case may be.

Other than cash items, there may be some items, such as losses, provisions, reserves and depreciation, which must be considered before the final accounts are prepared. It is done by passing adjustment entries. Adjustment entries are passed at the end of the accounting period to adjust various nominal accounts so as to find out net profit or net loss.

7.15 REFERENCES

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SELF ASSESMENT QUESTIONS

1. Why are adjustments entries are required to be made at the time of preparing Final Accounts. Give illustrative examples of any four such adjustment entries.
2. Differentiate between
   a. Outstanding expenses and prepaid expenses
   b. Outstanding income and Accrued income
   c. Interest on capital and Interest on Drawings
3. What are bad debts and provisions for bad debts?

UNIT-08 ERRORS AND THEIR RECTIFICATION

Objectives :

After going through this unit, you must be able to understand:

- Different types of errors;
- The procedure for locating errors;
- The meaning and importance of Suspense account; and
- Rectification of accounting errors by means of appropriate journal entries.

Structure :

8.1 TYPES OF ERRORS

Trial balance is prepared from the debit and credit balances of ledger accounts. The Trial balance amount shows a proof of arithmetical accuracy of the books of account. But it serves to prove onlythe arithmetical accuracy of the books. There are several types of errors which may exist and may remain undisclosed in spite of the agreement of the Trial Balance. Errors can broadly be divided into the following categories:

1. **Errors of Principle**- An error of principle is one where a transaction is recorded in total disregard to the fundamental principle of double entry i.e. not as per the rule of debit and credit or in violation of some other basic principle, Errors of principle are committed in those cases where a proper distinction between revenue and capital items is not made i.e. a capital expenditure is taken as a revenue expenditure or vice versa. Similarly, a capital receipt may have been taken as a revenue receipt or vice versa.

This distinction between capital and revenue is of paramount importance because any incorrect adjustment or allocation in this respect would falsify the final results as disclosed by both the profit and loss account and the balance sheet. Examples of such errors are:

a. Furniture purchased on credit wrongly recorded in Purchases Journal instead of the Journal Proper. i.e. Purchase account has been wrongly debited instead of the Furniture account. The item of capital expenditure has been treated as revenue expenditure.

b. Amount spent on ordinary repairs of building wrongly debited to Building account [fixed asset], instead of Repairs account [revenue expenditure]. Debiting this amount to fixed asset account means treating it as capital expenditure.

c. Material purchased for erection and wages paid to own staffs for installation of machinery have been included in purchases and wages account respectively. In fact, the cost of material purchased and wages so paid should be debited to Machinery account as it is a capital expenditure.

d. Salary paid to Mr. X has been written on credit side of the cash book as payment to Mr. X instead of Salaries account. the expense of salary is debited to Salary account and not to the personal account of the employee.

e. Commission paid for purchase of land is debited to commission account instead of to land account.

f. Inadequate or excess provision for bad and doubtful debts, discount on debtors and depreciation on fixed assets.

2. **Errors of Omission:** When a transaction has been omitted to be recorded in the books of account-either wholly or partially, it is an error of omission Thus, it is of the following two types;

a. **Complete omission:** Here the transaction is completely omitted from the books. Examples:

i. Failure to record completely credit purchases of goods in Purchase Journal

ii. An item on return from customers omitted to be recorded in Sales Return Jornal

b. **Partial omission:** This means that the transaction is entered in the subsidiary books but it is not posted in the ledger. Examples:

i. A credit purchase entered in the Purchase Journal but not posted to the credit of the supplier's or creditor's account

ii. Cash received from a customer on account of credit sales of goods entered on the receipts side of the Cash book but not posted to the credit side of the customer's or debtor's account

iii. Goods returned to supplier entered in the Purchase Return Journal but not posted to the debit of the supplier's or creditor's account.

Such errors do affect the agreement of Trial balance. Trial balance would not agree due to such errors, there would be either short debit or short credit.

3. Errors of Commission: These are most common type of errors. Here the error is the result of commission i.e. something being done which ought not to be done. These mistakes are committed because of ignorance, lack of proper accounting knowledge and carelessness of the ledger clerk. They are committed while recording transaction. Examples of such errors are

   a. Wrong amount entered in subsidiary books

   b. Entering the transaction in a wrong subsidiary book

   c. Wrong casting of subsidiary books. posting from the subsidiary book to the impersonal account in the ledger is done at the end of the period. At this time books [leaving Cash book and Journal Proper] are totalled and the posting with that total is made to impersonal account. The process of totalling the transactions at the end of period is called casting. If there is a mistake in getting the total , then it is called an error of casting. It can be an error of overcastting or undercasting. Error of casting affects only that account to which the total of the book is posted.

   d. Error of carry forward: It affects impersonal accounts like sales account, purchase account, purchase return account, sales return account, bills receivable account, bills payable account. Error of carry forward occurs when the total of one page is carried wrongly on the next page and thus ultimately making the casting of that book necessarily wrong.

   e. Error of posting: Posting is the second stage of accounting structure, first being recording in the subsidiary books. If some mistake is committed at the second stage of accounting, it must not be assumed that the first stage is also wrong. It should rather be taken for granted that recording in subsidiary books, its casting and carry forward are correct unless otherwise is stated. Error of posting affects only one account.

   f. Error arising in balancing the ledger accounts resulting in excess or short balance of the account.

4. Compensating Errors: These are errors that cancel each other, and because of this they are rather not simple to discover. They may be dissimilar in nature, but are of a similar amount. Examples;

   a. Underposting of the Purchase Journal may be compensated or cancelled out with the undercasting of the sales journal by a similar amount

b. Omission of posting of a certain amount on the debit side of an account may be compensated by excess posting of the similar amount on the debit side in some other account or accounts.

Compensating errors do not affect the agreement of the trial balanceSuch errors will remain even in spite of the fact that the trial balance agrees.

8.2 LOCATION OF ERRORS

If the Trial Balance disagrees, it is evident that there are some errors in the books of accounts and it should be located and rectified. Even if there is only a very small difference, it may be the net result of so many errors and must be rectified. The errors can be classified into two categories from the point of view of locating them:

1. **Errors which do not affect the agreement of the Trial Balance or Two-Sided Errors:**Errors of omission, errors of commission and error of compensating nature by themselves do not affect the agreement of the trial balance. The examples of these errors are:

   a. Omitting an entry altogether from the subsidiary book.

   b. Writing an entry in the wrong subsidiary book.

   c. Posting to wrong heads of account but on the correct side.

   d. Errors of Principle [e.g. treating purchase of machinery as purchase of goods].

   e. Compensating errors.

   f. Writing wrong amount in a subsidiary book.

The location of these types of errors is a difficult process. They are usually found out when statement of accounts are received by the business or sent to the customers or during the course of internal or external audit and sometimes by chance.

2. **Errors which affect the agreement of the Trial Balance or One-Sided Errors:** They are:

   a. Wrong casting and wrong carry forwards.

   b. Wrong balancing of an account.

   c. Posting the amount on the wrong side of an account.

   d. Posting wrong amount on the correct side of an account.

   e. Omission to post an amount from the subsidiary book to the ledger.

   f. Omission of an account balance from the Trial Balance.

g. Omission to post the total of the subsidiary books to the ledger.

h. Posting the same amount twice in an account.

i. Writing the balance of an account on the wrong side of the Trial Balance.

j. Wrong totalling of the Trial Balance.

k. Omission in taking the cash book balance to the Trial Balance.

Such errors are easy to be located since they are caught at an early stage. As soon as the trial balance does not tally, the accountant can proceed to find out these errors. The following steps will be useful in locating errors:

1. Check out totals: Add again the total of the two columns of the Trial Balance.

2. Ensure inclusion of all balances: See that the ledger balances are taken to Trial balance correctly and are entered on the appropriate columns.

3. Re-compute the ledger balances: It is done to check the error that may have been made in the balancing, totalling and the like.

4. Check the total of Debtors and Creditors: Check the schedule of Sundry Debtors and Sundry Creditors to ensure that they have been correctly arrived at.

5. See whether the cash and bank balances are written in the Trial Balance.

6. Check the posting from the book of original entry into the ledger accounts. Errors may be in the form of posting it twice or posting it into wrong account or to the wrong side of an account or unposted and so on. The casting of subsidiary books should be checked again;

   a. If the difference is very big, the balance in the various accounts should be compared with those of the previous period

   b. The exact difference in the Trial balance should be found out. The ledger should be gone through. It is possible that a balance equal to the difference has been omitted from the Trial balance. The difference should be found out and rectified

   c. If there is still a difference in the Trial balance, a complete checking is necessary. The posting of all the entries should be gone through.

8.3 RECTIFICATION OF ERRORS

Errors should not be corrected by overwriting. If it is ascertained that an error has been committed, immediately after making that entry, it should be corrected by making fresh entry after neatly crossing out the wrong entry. But if the errors are detected only after some time, i.e. at the time of preparation of final accounts, it should be corrected by making a rectification entry. The entries passed through the Journal proper for rectifying the errors in the books of accounts are known as rectifying entries.

8.3.1 RECTIFICATION OF ONE –SIDED ERRORS

These types of errors will cause disagreement of the Trial Balance because this error is committed only on one aspect of a transaction. It may be stated that the one-sided errors do not require any journal entry for rectification. It requires physical correction of wrong figures or an opposite entry in the same account.

8.3.2 RECTIFICATION OF TWO –SIDED ERRORS

These types of errors affect both sides of the account. So, for the correction of two-sided errors a complete rectification entry is necessary. Complete omission, error of principle, and wrong account posting are some common types of two- sided errors.

Example: Rectify the following errors:

i. *Sales to X Rs. 2,000 posted to his account as Rs. 200*

ii. *Sales to X Rs. 2,000 debited to his account as Rs. 200*

iii. *Sales to X Rs. 2,000 credited to his account as Rs. 200*

iv. *Sales to Y Rs. 5,600 posted to his account as Rs. 6,500*

v. *Purchases of Rs. 8,755 from X posted to his account as Rs. 5,578*

vi. *Purchases of Rs. 6,580 from X posted to his account as Rs. 8,560*

vii. *A credit purchase of furniture Rs. 9,000 from Z was posted as Rs. 900*

viii. *A credit sale to Rajesh of Rs. 10,000 posted as Rs. 1,000*

ix. *A cash sale to Amit of Rs. 10,000 posted as Rs. 1,000*

Solution: these errors will be rectified as follows:

i. *In this case since posted word is used, it will stand for the correct side. In this case, it stands for the debit side. Here since X's account has been debited by Rs. 200 as against Rs. 2,000, hence a further debit of Rs. 1,800 is required. Rectification will be done by giving an explanatory note on the debit side of X as under:*

"To short debit for sales [error rectified] Rs. 1,800"

ii. *There is a short debit to X's account of Rs. 1,800. This error will be rectified by giving a note on the debit side of X's account*

"To short debit for sales [error rectified] Rs. 1,800"

iii. It is a sales transaction and the personal account [of X] should have been debited. But instead of a debit, a credit of Rs. 200 has been given. Therefore

1. Wrong credit has to be cancelled. For this, give a debit of Rs. 200

2. Right debit has to be given of Rs. 2,000

Hence, X's account has to be debited by Rs. 2,200 [2,000+200] by giving the following note.

"To error rectified for credit sales Rs. 2,200"

iv. More debit has been given to Y's account by Rs. 900. Rs. 900 [6,500 5,600] will be written on the credit side by giving a note

"By excess debit on account of sales [now rectified] Rs. 900"

v. Less credit by Rs. 3,177 [8,755 5,578] has been given to X's account on account of credit purchases from him. Rectification will be made by the following note on the credit side of X's account

"By less credit for purchases [now rectified] Rs. 3,177"

vi. Rs. 8,560 has been credited to X's account instead of Rs. 6,580 i.e excess credit by Rs. 1,980 [8,560 6,580]. Rectification will be done by writing this amount on debit side by means of an explanatory note

"To excess credit for purchases [now rectified] Rs. 1,980"

vii. In this case, both the accounts are wrong, furniture account is short of debit of Rs. 8,100 and Z's account is short of credit of Rs. 8,100 and, therefore, it will be corrected by giving the following journal entry

Furniture account	Dr.	Rs. 8,100	
To Z			Rs. 8,100

viii. In this case, Rajesh account is wrong, Sales account can be wrong only when the recording in Sales Journal is wrong or total of the Journal is wrong. Individual item is posted only to the personal account, Rs. 9,000 will be debited to Rajesh's Account

ix. Here, sales account is wrong. Cash sales is recorded in the cash book and if the recording is right, then the cash book is right. There is no posting from the cash book to the cash account. It will be posted only to sales account [it is a cash sale and Amit's name is immaterial]. It will be corrected by giving a credit of Rs. 9,000 to sales account.

Example : The following errors affecting the accounts for the year 2015 were detected in the books of Das & Co. Calcutta

i. *Sale of old furniture for Rs. 5,000 was treated as sale of goods*

ii. *Rent of proprietor's residence Rs. 6000 was debited to Rent account*

iii. *Cash received from Rajesh Rs. 2,150 was credited to Brajesh*

Pass rectifying journal entries. State the nature of each of these mistakes

Solution:

RECTIFYING JOURNAL ENTRIES

S.No	***Particulars***	***L.F.***	***Dr. [Rs.]***	***Cr. [Rs.]***
i	*Sales A/c Dr.*		*5,000*	
	To Furniture A/c			*5,000*
	[Being sale of old furniture wrongly treated as sale of goods , now corrected]			
ii	*Drawings A/c Dr.*		*6,000*	
	To Rent A/c			*6,000*
	[Being rent of proprietor's residence wrongly debited to Rent A/c , now corrected]			
iii	*Brajesh A/c Dr.*		*2,150*	
	To Rajesh			*2,150*
	[Being cash received from Rajesh wrongly credited to Brajesh , now corrected]			

Nature of mistakes

i. *Error of Principle*

ii. *Error of Principle*

iii. Error of Commission

8.4 SUSPENSE ACCOUNT AND RECTIFICATION

A suspense account is a separate category of account code opened to record expenditure and/or income which, at least, for the time being cannot be properly allocated to specific budget-related expenditure or income account code. By definition, entries in suspense accounts are transitional and there is a presumption that there is no adequate authority for any item remaining in suspense over a period of time. For this reason, individual entries in suspense accounts must be capable of identification and balances in suspense must be reviewed regularly to confirm that their retention in suspense is justified.

Sometimes, it may so happen that location of errors may take a considerable time and the preparation of final accounts cannot be delayed. In such a case, the Trial balance is artificially made to agree by opening a Suspense account and putting the difference in the Trial balance to this account. if the debit total exceeds the credit total, the difference will be put along with the credit items as Suspense account and vice versa. However, such agreement of the Trial balance will not be real and as such efforts must be made to locate the errors later.

One- sided errors can be corrected by making a rectification entry in the account concerned, if they are located before the preparation of Trial balance. But if such errors are located only after Trial balance preparation and a Suspense account is opened with the difference in the Trial balance, their correction also should be done by passing journal entries. One should debit or credit the concerned account affected and the other aspect should be Suspense account.

Example: A book-keeper of a trading concern having failed to agree the trial balance, opened a suspense account and entered the difference in trial balance. The following errors were subsequently discovered:

a. Sales book was overcast by Rs. 200

b. Purchased furniture Rs. 3,000 was passed through purchases book and from there Furniture house account was posted Rs. 300

c. Sold goods to Ram Manohar Rs. 55 was posted as Rs. 550

d. Purchases book overcast by Rs. 80

e. Purchases return book was carried forward as Rs. 122 instead of Rs. 112

f. Sold goods Rs. 200 entered in the sales book as Rs. 2,000

You are required to find out the difference in the trial balance. Show suspense account. Pass necessary rectifying journal entries.

Solution:

RECTIFYING JOURNAL ENTRIES

S.No	***Particulars***	***L.F.***	***Dr. [Rs.]***	***Cr. [Rs.]***
a	*Sales A/c Dr.* *To Suspense A/c* *[Being the error in totalling of sales book , now corrected]*		*200*	*200*
b	*i. Furniture A/c Dr.* *To Purchases A/c* *[Being wrong recording of furniture in purchases book, now rectified]*		*3,000*	*3,000*
	ii. Suspense A/c Dr. *To Furniture house A/c* *[Being underposting to supplier account by [3,000-300] i.e. Rs. 2,700, now corrected]*		*2,700*	*2,700*
c	*Suspense A/c Dr.* *To Ram Manohar A/c* *[Being sale of goods wrongly overdebited to customer, now corrected]*		*495*	*495*
d	*Suspense A/c Dr.* *To Purchases A/c* *[Being overcastting of purchases book, now rectified]*		*80*	*80*
e	*Purchase return A/c Dr.* *To suspense A/c* *[Being error in carrying forward of total of purchases return book , now rectified]*		*10*	*10*
f	*Sales A/c Dr.* *To customer A/c* *[Being over posting in the Sales Book, now rectified]*		*1,800*	*1,800*

SUSPENSE ACCOUNT

Dr. ***Cr.***

Particulars	***L.F.***	***Amount [Rs.]***	***Particulars***	***L.F.***	***Amount [Rs.]***
To Furniture house		*2,700*	*By balance difference in the trial balance*		*3,065*
To Ram Manohar		*495*	*By sales*		*200*
To Purchases		*80*	*By purchases returns*		*10*
Total:		*3,275*	*Total:*		*3,275*

8.5 EFFECTS OF RECTIFYING ENTRIES ON PROFITS

Errors committed in a year may affect the profit of that year. This happens when the errors relate to such accounts which are taken into account while computing gross or net profit of the business. In other words, if the errors relate to such accounts which find their place in the Trading account or the Profit & Loss account, the errors will affect the profit of the business. For example: errors involving Purchases account, Sales account, Expense account, Income account will all affect the profit of the business. In case on account of errors such accounts are either not debited or unnecessarily credited, this will result in increase in profit of the business. Similarly, if on account of such errors such accounts are unnecessarily debited or are not credited, the errors will reduce the net profit of the business.

Example : Rectify the following errors. Prepare suspense account and find out effect of these errors on profit:

- *i.* *Purchased goods from Nathai Rs. 300, passed through Sales book*
- *ii.* *Received one bill from Arun Rs. 500, passed through Bills payable book*
- *iii.* *An item of Rs. 150 relating to prepaid rent account was omitted to be brought forward*
- *iv.* *An item of Rs. 40 in respect of purchases return , instead of being debited to the personal account from returns outward book, had been wrongly entered in the purchases book and posted therefrom wrongly to the debit of personal account*
- *v.* *Rs. 500 paid to Mehta Bros, against our acceptance were debited to Malhotra Bros account*
- *vi.* *Received final dividend of Rs. 20 from Ajit, whose account had already been written off as bad debt, was credited to a newly opened account and was included in the list of creditors.*

vii. *Bills received from Janki Das for repairs done to radio Rs. 150 and radio supplied for Rs. 950, was entered in the purchases book as Rs. 1,000*

Solution:

RECTIFYING JOURNAL ENTRIES

S.No	**Particulars**	**L.F.**	**Dr. [Rs.]**	**Cr. [Rs.]**
i	*Sales A/c Dr.*		*300*	
	Purchases A/c Dr.		*300*	*600*
	To Nathai A/c			
ii	*[Being purchase of goods passed through sales book, now corrected]*		*500*	
	Bills receivable A/c Dr.		*500*	*1,000*
	Bills payable A/c Dr.			
	To Arun A/c			
iii	*[Being receipt of bill passed through bills payable book, now corrected]*		*150*	*150*
	Prepaid rent A/c Dr.			
	To Suspense A/c			
iv	*[Being omission in bringing forward of prepaid rent, now corrected]*		*80*	*40*
	Suspense A/c Dr.			*40*
	To Purchases return A/c			
	To Purchases A/c		*500*	
v	*[Being error in posting of an item of purchases return to purchases book, now rectified]*			*500*
	Bills payable A/c Dr.			
	To Malhotra Bros A/c		*20*	

vi	*[Being error in debiting Malhotra Bros , now rectified]*			*20*
	Ajit A/c Dr.		*1,100*	
	To Bad Debt Recovered A/c			
vii	*[Being error in opening a new account of Ajit for an amount already written off as bad debt , now rectified]*			*950* *150*
	Electric Equipment A/c Dr.			
	To Purchases A/c			
	To Janki Das A/c			
	[Being wrong recording of repairs and radio purchased to purchases book, now rectified]			

SUSPENSE ACCOUNT

Dr. ***Cr.***

Particulars	***L.F.***	***Amount [Rs.]***	***Particulars***	***L.F.***	***Amount [Rs.]***
To balance [difference in trial balance]		*70*			
To Purchase return		*40*	*By Prepaid rent*		*150*
To Purchases		*40*			
		150	*Total:*		*150*
Total:					

STATEMENT SHOWING EFFECT OF ERRORS ON PROFIT

		Dr.	***Cr.***
i.	*Will reduce profits*	*Rs. 600*	-------
ii.	*No effect on profit*	---------	-------
iii.	*Will reduce profit*	*Rs. 150*	-------
iv.	*Will increase profit*	--------	*Rs. 80*
v.	*No effect*	----------	---------

vi.	*Will increase profit*	---------	*Rs. 20*
vii.	*a. Will reduce profits*	*Rs. 150*	--------
c.	*will increase profits*	----------	*Rs. 1,000*
	Total:	*900*	*1,100*

Total Increase	*Rs. 1,100*
Less Total debits	*900*
Net increase	***200***

8.6 SUMMARY

Trial balance serves to prove only the arithmetical accuracy of the books. There are several types of errors which may exist and may remain undisclosed in spite of the agreement of the trial balance. Some of these errors do not affect the agreement [Two Sided errors] of the Trial balance, but some others affect [One sided errors].

Sometimes, the location of errors may take a considerable time and the preparation of final accounts cannot be delayed. In such a case, the Trial balance is artificially made to agree by opening a Suspense account and putting the difference in the Trial balance with this account. If the debit total exceeds the credit total, the difference will be put along with the credit items as Suspense account and vice versa,.

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SELF ASSESMENT QUESTIONS

1. Explain the different types of errors with suitable example and state how they affect the Trial balance.

2. “A trial balance is only a prima facie evidence of the accuracy of the books of accounts”. Comment

3. In case of disagreement of the trial balance what steps would you take to locate the errors?

4. Explain And illustrate Suspense Account.

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Bachelor of BusinessAdministration

BBA-106

Financial Accounting

BLOCK

3

CONSIGNMENT AND JOINT VENTURES

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UNIT-09 CONSIGNMENT ACCOUNT-I

Objectives :

After going through this unit, you must be able to understand:

- The concept and meaning of consignment;
- Features of consignment;
- The distinction between consignment and sale;
- Preparation of consignment account; and
- The accounting treatment of consignment transactions in the books of consignor and consignee

Structure :

9.1 CONCEPTS AND MEANING OF CONSIGNMENT

The increasing size of the market is making more and more difficult for the manufacturer or wholesaler to come in direct contact with customers living at far off distance. This has made imperative for him to enter into an agreement with a reliable local trader who can sell goods on his behalf and at his risk for an agreed amount of commission. Such a dispatch of goods from one person to another person at a different place for the purpose of warehousing and ultimate sale is termed as consignment. A consignment may be defined as a shipment of goods by a trader to an agent for sale on commission on the sole risk and account of the former. It is the sending of a quantity of goods by one person to another at a different place to be sold by the latter as the agent of the former. Goods so sent are termed as ‘goods sent on consignment’, the sender is called ‘Consignor’ and the recipient is called ‘Consignee’.

The goods sent by the trader to his agent for the purpose of sale by the latter on commission basis are called ‘consignment outwards’, whereas for the agent, such goods as are to be sold on behalf of and on account of principal, are known as ‘consignment inwards’

9.2 PARTIES TO CONSIGNMENT

A manufacturer or a wholesaler often finds it quite convenient and profitable to sell goods through the agent who sells goods on behalf of the sender of goods against commission. There are two parties involved in this process:

Consignor: The person who sends the goods is called ‘consignor’ or ‘principal’.

Consignee: The person to whom the goods are sent is called ‘consignee’ or ‘agent’.

Sending goods on consignment is neither a sale by the consignor, nor a purchase by the consignee. The consignee cannot be treated as consignor’s debtors for the goods received on consignment. The relationship created between the parties is that of an agent and a principal. This relationship is governed by the law of agency. An agent is entitled to be reimbursed for any expenses he may incur on behalf of his principal and also to commission for his services in selling or buying goods or for doing any other act on behalf of his principal. The agent is expected to exercise reasonable care in protecting his principal’s goods from damage, in extending credit and in collection of debts from customers.

9.3 FEATURES OF CONSIGNMENT

The main features of a consignment transaction can be put as follows:

1. Consignment of goods is not a sale. It is mere transfer of possession of goods.
2. The consignee sells goods at the risk of the consignor. He is not responsible for any loss or destruction of goods.
3. The sales proceeds belong to the consignor and the consignee merely gets commission and expenses that he might have incurred.
4. The relationship between consignor and consignee is that of a Principal and an Agent
5. The consignee is not responsible for any loss or destruction of the goods belonging to the consignor provided he has taken reasonable care in protecting the goods. This is so because the goods belong to the consignor and they are to be sold at his risk and account.
6. If there are any goods which remain unsold on any date, they belong to the consignor.

9.4 DISTINCTION BETWEEN SALE AND CONSIGNMENT

The difference between sale and consignment can be put as follows:

a. Transfer of ownership: In case of sale, the ownership of the goods is transferred from the seller to the buyer. While in case of consignment, goods remain the property of the consignor till they are sold by the consignee.

b. In consignment, two parties are consignor and the consignee. In sale, the parties are known as buyer and seller.

c. In the case of consignment the goods are sold by the consignee or agent against commission, while in sale, they are sold against price.

d. The consignor bears the expenses in the case of consignment but in sale, after its completion, the expenses incurred by the buyer will be borne by him.

e. Return of goods: Goods once sold cannot be returned unless they are defective and the seller agrees to take them back. While in case of consignment unsold goods remain lying with consignee or returned back to the consignor

f. Nature of relationship: The relationship between the seller and the buyer, if the goods are sold on credit, is that of debtor and creditor. While in case of consignment the relationship between the consignor and the consignee is that of a principal and an agent.

g. Transfer of risk: In case of sale, the risk also passes with the transfer of ownership. In other words, once the goods are sold, the buyer will bear the loss even if the goods are still in the possession of the seller. In case of consignment the ownership does not pass to the consignee and, therefore, the risk remains with the consignor in the event of goods being lost or destroyed.

h. In consignment, the consignee sends an Account sales to the consignor from time to time giving details about the goods sold and expenses incurred by him. In the case of sale, the buyer need not submit any Account sales to the seller.

9.5 IMPORTANT TERMS IN CONSIGNMENT

1. **Proforma invoice:** It is a statement prepared by the consignor stating quantity, quality and price of goods. It is sent with goods despatched to consignee. A Proforma invoice is different from invoice. Invoice implies that a sale has taken place. It is a statement describing the goods despatched to the buyer and showing the total amount due by him to the seller. A Proforma invoice is simply a statement of information in the form of invoice to apprise the party, who has not bought the goods but

shall be having their possession, or dealing with them, of certain essential particulars of the goods. Such an invoice is sent by the intending seller to his agent or the intending buyer before the sale actually takes place. It does not show that the person to whom it is sent is indebted to the sender.

2. **Account sales:** It is a periodical statement rendered by the Consignee to the Consignor containing details of goods received, sales made, expenses incurred, commission charged, remittances made and balance due by him to the consignor.

   The following is a specimen of account Sales:

   Account sales of 50 radiograms ex S.S. Pedro received and sold on account of Robbins & Sons, Chicago by

M/s Chiman Lal Desai & Co. Mumbai

Particulars		*Rs.*	*Rs.*
40 radiograms at Rs. 1,200 per radiogram		*48,000.00*	
10 radiograms at Rs. 1,100 per radiogram		*11,000.00*	*59,000.00*
Less charges:			
Dock Dues	*700*		
Customs Duty	*2,000*		
Freight	*1,300*		
Godown rent	*500*	*4,500.00*	
Commission at 5 per cent		*2,950.00*	*7,450.00*
			51,550.00
Less draft accepted			*20,000.00*
Balance due, bank draft enclosed			*31,550.00*

E & O.E. *For Messrs Chiman lal Desai & Co*

[Sd]

Ashok Kumar

Mumbai, the 15th Jan, 2016 *Manager*

3. **Commission-** it is the remuneration payable to the consignee for sale made by him. This can be simple, overriding and del-credere. Simple commission is calculated as per terms laid down by the consignor. Usually this is a fixed percentage on total sales. In order to give further incentive, sometimes an extra commission termed as overriding commission is allowed to consignee, in case the sales exceed a specific amount. It is also calculated on total sales. Where the consignee agrees to meet any loss

which the consignor may suffer by reason of bad debts, one more extra commission, known as del-credere commission, is given to consignee. This is also normally calculated on total sales.

Example: Gopi Cycles [P] Ltd., Hyderabad, sent 2,000 dynamos costing Rs. 50 each for sale on consignment basis to Ramoo of Vijaywada, subject to the following terms:

i. *Normal selling price per dynamo Rs. 60*

ii. *Consignee's commission to be calculated as under*

a. *5 percent on normal selling price*

b. *1 percent additional commission if selling price is more than normal price; and*

c. *1/2 percent del-credere commission on total sales for guaranteeing collection of credit sales*

Ramoo reported sales as follows:

Cash sales:	***Rs.***
500 dynamos at Rs. 60 each	*30,000*
200 dynamos at Rs. 75 each	*15,000*
***Credit sales**:*	
400 dynamos at Rs. 75 each	*30,000*
400 dynamos at Rs. 80 each	*32,000*
Total	*1,07,000*

Ascertain the commission due to consignee:

Solution:

STATEMENT OF COMMISSION DUE TO CONSIGNEE

	Rs.
Normal [or simple] commission	
*1,500*60*5/100*	*4,500*
Additional [or overriding] commission	
*77,000*1/100*	*770*
Del –credere commission	
*1,07,000*1/2/100*	*535*
Total:	*5,805*

4. **Direct expenses:** These are expenses which are incurred for placing the goods in a saleable condition. All expenses till the goods reach the godown of the consignee come in this category. These expenses are of a non-recurring nature and increase the value of goods. Examples of such goods are freight, carriage, insurance, loading, and unloading charges.

5. **Indirect expenses:** These are expenses incurred after the goods reach the consignee's godown. They are of a recurring nature and do not increase the value of goods. Examples of such expenses are- godown rent, storage charges, advertisement expenses, salaries of salesmen, etc.

   The distinction between direct and indirect expenses is of special importance at the time of the valuation of the unsold stock. Direct expenses form a part of the cost and therefore, a proportion of such expenses is included in the cost of stock, while the indirect expenses do not form part of the cost and therefore, excluded while valuing the unsold stock.

6. **Advance:** The consignor may ask the consignee to deposit some money with him to be kept by him as security in respect of the goods sent by him on consignment. It is usually a certain percentage of the value of goods sent on consignment. The amount is adjusted against the amount due from consignee when the accounts are finally settled. However, the consignor may like to keep with himself a certain percentage of value of the goods lying with the consignee. In such a case advance will be adjusted only to the extent of the proportionate goods sold.

   Example: Goods of Rs. 50,000 are sent on consignment to A who sells away 50 percent of the goods for Rs. 40,000. Consignor required that 10 percent of the value of the goods should be kept as an advance with him. A's expenses and commission amount to Rs. 5,000. The amount to be sent by A will be calculated as follows:

	Rs	*.Rs.*
Sales value of the goods		*40,000*
Less commission and expenses	*5,000*	
Advance deposited 10 percent of Rs. 25,000	*2,500*	*7,500*
Amount to be sent by A		*32,500*

Thus 10 percent of the value of stock lying with the consignee i.e. Rs. 2,500 out of initial advance of Rs. 5,000 will still remain as advance with the consignor till these goods are finally sold.

9.6 ACCOUNTING TREATMENT

The transaction relating to each consignment are recorded in such a way that the profit or loss of each consignment can be worked out separately. For this purpose the consignor prepares a Consignment Account relating to each consignment to which all concerned expenses including the cost of goods consigned are debited and the sale proceeds and the closing stock are credited. In addition, he also maintains a Consignee's account in order to compute the amount due from him. The Consignee, on the other hand, simply maintains Consignor's account in his books to which he debits the amounts remitted to the consignor, the expenses incurred by him in relation to the consignment and the commission due to him. Consignor's Account is credited mainly by the amount of sale proceeds.

9.6.1 BOOK OF CONSIGNOR

The consignor will find out profit or loss on each separate consignment of goods. Thus, he will open separate consignment accounts and transactions relating to each consignment are recorded in relevant consignment accounts. They may be named as 'Consignment to Mumbai A/c', 'Consignment to Delhi A/c', etc.

Following are the accounting entries:

1. *When goods are sent on consignment:*

   Consignment account dr.

   To Goods sent on consignment account

2. *When advance is received from the consignee:*

   Cash/ bank/ bill receivable account dr.

   To consignee's personal account

3. *When expenses are incurred by the consignor:*

   consignment account dr.

   To bank account

4. *When goods are received by the consignee:*

   No entry is made

5. *When expenses are incurred by the consignee:*

   consignment account dr.

   To consignee's personal account

6. *When sales are made by the consignee:*

   consignee's personal account dr.

   To consignment account

7. *For commission earned by the consignee:*

   consignment account dr.

   Credit consignee's personal account

8. *For stock at the end remaining unsold with the consignee:*

   stock on consignment account dr.

   To consignment account

9. *For profit or loss on consignment:*

consignment account dr.

To General profit or loos

10. *For the settlement of account with the consignee:*

    Bank/ bill receivable account dr.

    To consignee's personal account

11. *The 'Goods sent on consignment Account' is transferred to purchase account or trading account by passing the following entry:*

    Goods sent on consignment account dr.

    To Purchases or trading account

9.6.2 BOOK OF CONSIGNEE

As the goods consigned to consignee are not in the nature of sale, the consignee does not treat the consignor as his creditor and no entry is passed in his books on the receipt of such goods. He, however, maintains a stock register, where he records full details of goods so received. Following is the procedure for recording transactions in the books of consignee:

1. On receipt of goods: no entry is passed. Details are recorded in a register by way of memorandum record. It is not the part of double entry system.
2. For remitting cash as advance or accepting a B/R as security:

   Consignor's personal account dr.

   To Bills payable account or bank account
3. On incurring expenses- consignee takes delivery of goods and sells them in the market. For doing so, he invariably incurs some expenses. Entry is:

   Consignor's personal account dr.

   To Bank or cash account or party's account
4. On making cash sales:

   Cash Account dr.

   To consignor's personal account
5. For credit sales:

   To consignment debtors account dr.

   To consignor's personal account
6. For commission earned on sales:

   Consignee's personal account dr.

   To commission account

7. For collection debts:

   Bank Account dr.

   To consignment debtor's account

8. For bad debts, if any:

   a. If no del credere commission is paid:

      Consignor's account dr.

      To consignment debtor's account

   b. If del credere commission is paid:

      Bad debts account dr.

      To consignment debtor's account

9. On remitting balance to consignor:

   Consignor's personal account dr.

   To cash or bank account

10. For unsold stock lying with consignee: No entry is made in the books of consignee

9.7 SUMMARY

Consignment is the shipment of goods by a trader to an agent for sale on commission on the risk and account of the trader. The relationship between consigner and consignee is that of principal and agent. Sending goods on consignment is neither a sale by the consignor, nor a purchase by the consignee. Consignment and sale are different. Commission payable to agent or consignee may be normal, del credere or overriding. The purpose of del credere commission is that the consignee covers the risk of loss due to bad debts. The consignor ceases to be responsible for any loss of this type. The consignee send to the consignor on final sale of goods or at periodical intervals a statement of account known as Account sales. The consignor makes accounting entries in his books on receipts of the Account sales. The consignee also records the transaction in his books..

Example; Bush Radio & Co., Delhi sent on consignment to Chhadda & Co., Calcutta 100 radio sets, invoiced at Rs. 100 each on January 7, 2016. Bush Radio & CO. Paid Rs. 1,000 on the same day for despatching goods to the consignee. Consignee remitted Rs. 5,000 as an advance by bank draft on January 14. The consignee is entitled to a commission of 10% on the sale proceeds. On receipt of goods the consignee paid Rs. 1,000 for freight and Rs. 500 for godown charges. On January 28, Chhadda & Co. sent an Account sales showing that the radio sets have realised Rs. 200 each. He remits the amount due to Bush Radio & Co.. Pass journal entry and prepare ledger accounts in the books of the consignor and consignee.

Solution:

Books of Bush Radio & Co.

JOURNAL

Date	*Particulars*	*L.F.*	*Dr. ₹ Amount*	*Cr. ₹ Amount*
2016 Jan 7	*Consignment to Calcutta A/c Dr.* *To goods sent on consignment A/c* *[Being cost of consignment sent to Chhadda & Co.]*		*10,000*	*10,000*
7	*Consignment to Calcutta A/c Dr.* *To Bank A/c* *[Being expenditure incurred on despatching of goods]*		*1,000*	*1,000*
14	*Bank A/c Dr.* *To Chhadda & Co.* *[Being receipt of an advance payment from the consignee]*		*5,000*	*5,000*
28	*Consignment to Calcutta A/c Dr.* *To Chhadda & Co.* *[Being expenses paid by the consignee]*		*1,500*	*1,500*
28	*Chhadda & Co Dr.* *To consignment to Calcutta A/c* *[Being the gross proceeds of sales made by the consignee]*		*20,000*	*20,000*
28	*Consignment to Calcutta A/c Dr.* *To Chhadda & Co.* *[Being commission payable on sale proceeds]*		*2,000*	*2,000*
31	*Bank A/c Dr.* *To Chhadda & Co.*		*11,500*	*11,500*

	[Being balance payment received from the consignee]			
31	*Consignment to Calcutta A/c Dr.* *To Profit & Loss A/c* *[Being profit on consignment transferred to profit & Loss Account]*		*5,500*	*5,500*
31	*Goods sent on consignment A/c Dr.* *To Trading A/c* *[Being goods sent on consignment transferred to trading account]*		*10,000*	*10,000*

LEDGER

Consignment to Calcutta Account

Dr. ***Cr.***

Date	*Particulars*	*Amount* ₹	*Date*	*Particulars*	*Amount* ₹
2016 Jan 7	*To goods sent on consignment A/c*	*10,000*	*Jan 28*	*By Chhadda & Co.*	*20,000*
7	*To Bank A/c [consignors expenses]*	*1,000*			
14	*To Chhadda & Co. [Consignees expenses]*	*1,500*			
28	*To Chhadda & Co. [Consignees' commission]*	*2,000*			
31	*To Profit & Loss A/c [Profit transferred]*	*5,500*			
	Total:	*20,000*		*Total:*	*20,000*

Goods sent on Consignment Account

Dr. ***Cr.***

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2001			*Jan 7*		
Jan 30	*To Trading A/c*	*10,000*		*By Consignment to Calcutta A/c*	*10,000*
	Total:	*10,000*		*Total:*	*10,000*

Chhadda & Co. Account

Dr. ***Cr.***

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2016	*To consignment to Calcutta A/c [sale proceed]*	*20,000*	*Jan*		
Jan 28			*2016*		
			14	*By Bank A/c [[Advance]*	*5,000*
			28	*By Consinment to Calcutta A/c [Expenses]*	*1,500*
			28	*By Consinment to Calcutta A/c [Commission]*	*2,000*
			28	*By Bank A/c [Balance received]*	*11,500*
	Total:	*20,000*		*Total:*	*20,000*

Books of Chhadda & Co.

JOURNAL

Date	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
2016 Jan 14	*Bush & Co. Dr.*		*5,000*	
	To Bank A/c			*5,000*
	[Being advance paid by the consignee]			
15	*Bush & Co. Dr.*		*1,500*	
	To Cash/ Bank A/c			*1,500*
	[Being expenses incurred on consignment]			
28	*Bank A/c Dr.*		*20,000*	
	To Bush & Co.			*20,000*
	[Being cash sales on consignment]			
28	*Bush & Co. Dr.*		*2,000*	
	To Commission A/c			*2,000*
	[Being commission due on goods sold]			
31	*Bush & Co. Dr.*		*11,500*	
	To Bank A/c			*11,500*
	[Being balance payment made]			

LEDGER

Bush & Co. Account

Dr. ***Cr.***

Date	*Particulars*	*Amount ₹*	*Date*	*Particulars*	*Amount ₹*
2016			*Jan 31*		
Jan14	*To Bank A/c*	*1,500*		*By Bank A/c [Sales]*	*20,000*
14	*To Bank A/c [Advance]*	*5,000*			
14	*To Commission A/c*	*2,000*			
14	*To Bank A/c [Balance]*	*11,500*			
	Total:	*20,000*		*Total:*	*20,000*

Commission Account

Dr. ***Cr.***

Date	*Particulars*	*Amount ₹*	*Date*	*Particulars*	*Amount ₹*
2016			*Jan 28*		
Jan 31	*To Profit & Loss A/c*	*2,000*		*By Bush & Co. A/c*	*2,000*
	Total:	*2,000*		*Total:*	*2,000*

9.8 REFERENCES

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SELF ASSESMENT QUESTIONS

1. Define Consignment. State its features
2. Distinguish between consignment and sale.
3. Write short notes on
   i. Book of Consignor
   ii. Book of Consignee

UNIT-10 CONSIGNMENT ACCOUNT-II

Objectives :

After going through this unit, you must be able to understand:

- How transactions are recorded in ledger accounts in consignor's and consignee's book:
- The procedure of computation of unsold stock; and
- The process of computation of normal and abnormal losses and their treatment in the books of account.

Structure :

10.1 DIRECT RECORDING IN THE LEDGER

A proper record of all transactions relating to a particular consignment is necessary for ascertaining Net Profit or Net Loss on each separate consignment.

Consignor will open the following accounts:

a. **Consignment account:** Since this account is opened to know the profit or loss on account of consignment; it is a nominal account in nature.

b. **Consignee account:** This account shows balance due to or from the consignee. It is a personal account in nature

c. **Goods sent on consignment account:** This is a real account. When goods are sent to consignee this account is credited and when goods are returned by consignee, it is debited

The above accounts are maintained in respect of each of the consignments. For example, if goods have been sent on Consignment to Mumbai, Chennai and Delhi, Consignment Account, Consignee's Account and Goods sent on Consignment Account will be maintained in respect of each of these consignments.

Proforma of the above three ledger accounts in the books of the consignor are given below:

Books of the Consignor

CONSIGNMNET TO MUMBAI ACCOUNT

Dr. Cr.

Particular	Amount [Rs.]	Particulars	Amount [Rs.]
To Goods sent on consignment A/c	....	By Consignee's personal A/c	
To Bank expenses	....	Cash sales	....
To Consignee's personal A/c		Credit sales	....
- Expenses	....	By Goods sent on consignment A/c- Returns by consignee	....
To Consignee's personal A/c		By Stock on consignment A/c	
- Commission	....	- Unsold stock	....
To Consignee's personal A/c		By Profit & Loss A/c	
- Bad debts	....	- Loss transferred	....
To Profit & loss A/c			
- Profit transferred	………..	Total:	………...
Total:			

CONSIGNEE'S PERSONAL ACCOUNT

Dr. Cr.

Particular	Amount [Rs.]	Particulars	Amount [Rs.]
To Consignment A/c - Sales proceeds	....	By Cash/Bank/B/R A/c [Advance]	....
		By Consignment A/c - Expenses of consignee	....
		- Commission	....
		By Bank or Balance c/d	....
Total:	……….	Total:	………..

GOODS SENT ON CONSIGNMNET ACCOUNT

Dr. Cr.

Particular	Amount [Rs.]	Particulars	Amount [Rs.]
To Consignment A/c - Goods returned	....	By Consignment A/c - Goods sent	....
To Purchase or Trading A/c - Transfer	....		
Total:	………..	Total:	……….....

Consignee will open the following accounts:

a. **Consignor's Personal account.**

b. **Commission account**

Proforma of these ledger accounts in the books of the consignee are given below:

Books of the Consignee

CONSIGNOR'S PERSONAL ACCOUNT

Dr. Cr.

Particular	Amount [Rs.]	Particulars	Amount [Rs.]
To Cash/ Bank A/c - Expenses To Bank/ Bills payable A/c - Advance To Commission A/c - Consignee's Commission Total:	....	By Bank- Cash sales By Consignment debtors A/c - Credit sales By Bank- final settlement or balance c/d Total:	....

COMMISSION ACCOUNT

Dr. Cr.

Particular	Amount [Rs.]	Particulars	Amount [Rs.]
To Bad Debts A/c [if del credere commission is allowed] To Profit & Loss A/c - Balance Total:	 .... ---------	By Consignor's Personal A/c - Consignee's Commission Total:	....

10.2 UNSOLD STOCK

At the time of submitting the account sale, a part of goods consigned will still be unsold and will be lying with the consignee. In order to calculate net profit or loss on consignment the unsold stock should be valued and accounted for.

10.2.1 VALUATION OF UNSOLD STOCK

It is often seen that total stock sent on consignment is not always sold away. In order to bring such unsold stock in the balance sheet of the consignor, it is necessary to calculate the value of such unsold stock. The stock left with consignee is valued at a price which will include:

i. Proportionate cost price and;

ii. Proportionate direct expenses i.e. proportionate expenses incurred both by the consignor and the consignee till the goods reach the godown of the consignee.

Moreover, the fundamental principle of accounting regarding valuation of stock should also be taken into consideration i.e. stock should be valued at cost or market price whichever is less. Cost price stands for Cost + proportionate direct expenses.

Thus cost price for this purpose is arrived at after including proportionate expenses of non-recurring [direct] nature whether incurred by consignor or consignee, i.e. all such expenses which are incurred to bring the goods into saleable condition. Expenses of recurring nature [or selling expenses] are not added.

Examples of expenses which must be added are freight, carriage on purchase, export and import duties or customs duties, dock dues, insurance of goods in transit, loading and unloading charges etc. All these expenses are incurred to place the goods in a saleable condition.

Examples of expenses to be ignored are warehousing, establishment expenses, carriage on sales or outwards, packing expenses, godown rent and charges, insurance of godown or warehouse, advertisement, salesmen's expenses. Expenses incurred by the consignee for bringing the goods up to godown are non-recurring expenses.

10.2.2 TREATMENT OF UNSOLD STOCK

Since the value of unsold stock affects the profit or loss on any consignment, its valuation and recording in the books of consignor is very important. It is shown on the credit side of Consignment Account for which the following journal entry will be passed.

Consignment Stock A/c Dr.

To Consignment A/c

[Being the value of closing stock]

The consignee however will not pass any entry for the closing stock. It is because he is not the owner of the goods and does not pass any entry even when he receives or returns the goods.

Example: G. Mehta consigns 100 radiograms to H. Singh. Each radiogram costs Rs. 800.

G. Mehta pays the following expenses:

	Rs.
Freight	*1,000*
Insurance	*400*
Carriage	*500*

H. Singh pays the following expenses:

Customs duty	*2,000*
Dock dues	*500*
Godown rent	*500*
Salary to salesman	*500*

At the end of the year 25 radiograms remained unsold with H. Singh. The market value of each radiogram is Rs. 850. You are required to calculate value of stock lying with H. Singh.

Solution:

STATEMENT SHOWING VALUE OF STOCK

PARTICULARS	*Rs.*	*Rs.*
Cost of 25 radiogram @ Rs. 800 per radiogram		*20,000.00*
¼ of direct expenses [i.e. 25/100]		
Freight	*250.00*	
Insurance	*100.00*	
Carriage	*125.00*	
Customs duty	*500.00*	
Dock dues	*125.00*	*1,100.00*
		21,100.00

*Market value of stock is Rs. 25 * 850= Rs. 21,250*

Cost being less and therefore

25 radiograms should be valued at Rs. 21,100.00

10.3 LOSS OF GOODS

In the course of consignment transaction some loss of stock may occur. It may be in the course of transit before or after taking delivery of the goods by the consignee or it may occur at the godown of the consignee. In case goods sent on consignment is lost on the way, then its treatment in the books of account depends upon the nature and type of loss.

10.3.1 NORMAL LOSS

Loss of stock is said to be normal loss only when such loss is unavoidable, natural and is due to inherent characteristics of commodity, e.g. evaporation, drying, sublimation, etc. In such a case the value of stock left unsold with consignee is arrived at by inflating its price. For this, first of all the total cost of total stock [without considering any normal loss] is calculated. Then this total cost is assigned to the stock as diminished by normal loss. Now in this proportion, as the total stock [duly reduced by the normal loss] bear to the total cost, the cost of stock left with consignee is calculated.

The following formula is applied in valuation of closing stock:

$$\text{Value of closing stock} = \frac{\text{value of goods sent} * \text{quantity in stock}}{\text{Net quantity received by the consignee}}$$

Example: A consigned 2,000 tonnes of coal @ Rs. 50 per tonne to B of Delhi. He paid Rs. 20,000 as freight. Due to normal wastage only 1,950 tonnes were received by B. He also paid Rs. 5,000 as unloading and cartage charges. The goods unsold amount to 650 tonnes. You are required to calculate the value of closing stock.

Solution:

	Rs.
Cost price of 2,000 tonnes of coal @ Rs. 50 per tonne	*1,00,000.00*
Freight paid by the consignor	*20,000.00*
Unloading and cartage charges paid by consignee	*5,000.00*
Cost of 1,950 tonnes	*1,25,000.00*

Cost of 650 tonnes $= \frac{650}{1,950} * 1,25,000 =$ *Rs. 41,667*

10.3.2 ABNORMAL LOSS

Abnormal loss of stock is that which is not natural and unavoidable. It is normally caused by theft, fire, pilferage, abnormal breakage, etc. In case of abnormal loss, price is not inflated as is done in the case of normal loss. Abnormal loss is calculated in just the same way as the stock at the end after taking into consideration proportionate expenses incurred on it and is credited to consignment account and debited to profit and loss account. In case the stock is insured, the excess of loss over insurance claim, if any, is debited to profit and loss account and amount of insurance claim is debited to claim account and the total of the two is credited to consignment account. In any case, total loss, whether insured or not, is shown in the consignment account on the credit side.

The journal entries for treatment of abnormal loss, in the books of consignor, will be as follows:

i. Abnormal loss account [with the total amount of loss] dr.

To Consignment account

ii. Insurance company [with recoverable amount] dr.

Profit & Loss account [with irrecoverable amount written off as a loss] dr.

To Abnormal loss account [with total amount of loss]

Example: A consigned to B 100 cases of tea costing 100 per case. He Paid Rs. 1,000 as freight and cartage. B could take delivery of only 90 cases since 10 cases were lost in transit. He paid Rs. 2,000 as unloading and carriage charges. At the end of the year he reported that he has sold away 80 cases at Rs. 150 per case. You are required to calculate:

i. The value of abnormal loss

ii. The value of closing stock

Solution:

i. VALUE OF ABNORMAL LOSS

	Rs.
Cost of 100 case @ Rs. 100 per case	*10,000*
Direct expenses incurred by the Consignor	*1,000*
Total cost of 100 cases	*11,000*

$$\text{Value of Abnormal Loss} = \frac{\text{Total cost * units of abnormal loss}}{\text{Total Units to be received by the Consignee}}$$

$$= \frac{\text{Rs. } 11{,}000 * 10}{100} = \text{Rs. } 1{,}100$$

ii. VALUE OF CLOSING STOCK

	Rs.
Total cost of 100 cases calculated as above : Rs. 11,000	
Cost of 10 cases [i.e. units of closing stock]	*1,100*
Add : proportionate expenses incurred by the consignee	
$\frac{\text{Rs. } 2{,}000 * 10}{90}$	*222*
	1,322

10.3.3 WHERE NORMAL AND ABNORMAL LOSSES OCCUR SIMULTANEOUSLY

In the above examples, we have considered only one type of loss at a time. But there are situations involving both types of losses simultaneously. The consideration depends on the time sequence of the losses.

Example: From the details of consignment given below you are required to calculate i.) abnormal loss ii.) amount of abnormal loss to be charged to profit and loss account and iii.) stock at end

- *i. 10,000 litres of nitric acid at Rs. 20 per litre*
- *ii. Freight Rs. 5,000 and insurance Rs. 5,000 paid by consignor*
- *iii. Consignee has spent Rs. 1,000 on selling. He is also entitled to 5% commission on sales*
- *iv. 2,000 litres of acid was lost in transit due to breakage of jars. The insurance compay admitted the claim for Rs. 35,000*
- *v. Sales – 5,700 litres at Rs. 25 per litre*
- *vi. The consignee is allowed a normal loss of 400 litres*

Solution:

		Rs.
Cost of 10,000 litres at Rs. 20 per litre		*2,00,000*
Add : non-recurring expenses – freight and insurance paid		*10,000*
Cost of 10,000 litres		*2,10,000*
i.) Abnormal loss = $\frac{2{,}10{,}000}{10{,}000} * 2{,}000$	*42,000*	
Less : amount admitted by insurance company	*35,000*	

ii.) Net loss to be charged to profit and loss account	*7,000*
iii.) Value of stock at end:	
Cost of 10,000 litres of acid	*2,10,000*
Less: 2,000 litres of abnormal loss	*42,000*
Cost of 8,000 litres of acid received by the consignee	*1,68,000*
Less: 400 litres of normal loss	*NILL*
Cost of 7,600 litres of acid	*1,68,000*

Stock at end quantity [7,600 – 5,700] = 1,900 litres

Value of stock = $\frac{1,68,000}{7,600}$ ** 1,900 = Rs. 42,000*

10.4 SUMMARY

Sometimes the consignee is not able to sell all goods consigned to him The stock left unsold with the consignee is valued at cost plus proportionate expenses of non recurring nature. Such expenses include expenses of the consignee also for bringing the goods up to godown.

In case, goods sent on consignment are destroyed or damaged or lost on the way, its treatment in the books of account depends upon the nature and type of loss whether it is normal or abnormal. Abnormal loss is treated in consignor's books depending on whether goods are insured or not and how much claim of loss has been accepted by insurance company. The net loss on account of abnormal loss is transferred to profit and loss account.

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SELF ASSESMENT QUESTIONS

1. Explain the rules of posting of transactions relating to a particular consignment in a ledger with examples.

2. What are unsold stocks? Discuss the valuation and treatment of unsold stock.

3. Explain the conditions of loss of stock in a consignment and their treatment

4. What procedure is followed for valuation of closing stock when the abnormal and normal losses occur simultaneously? Explain and illustrate.

UNIT-11 CONSIGNMENT ACCOUNT III

Objectives :

After going through this unit, you must be able to understand:

- The procedure of computation of Proforma invoice price and its treatment in the books of accounts;
- The concept of cost price and invoice price; and
- The loading, items involved in loading and its adjustment in the books of account.

Structure :

11.1 CONCEPT OF INVOICE PRICE

Invoice price is the manufacturer's initial charge to the dealer including freight, destination or delivery charges. This price may not reflect the dealer's final cost due to rebates, allowances, discounts and incentive awards the dealer may receive. The consignee is not able to know the actual cost of the goods sent by the consignor to him and hence he cannot find out the profit or loss being made by the consignor on these goods. The consignor adds the profit margin to the cost of the goods and an invoice is prepared showing the invoice price of the goods. When goods are so sent by the consignor, he debits the consignment account with the invoice value of the goods. But at the end of the year, for finding out true profit or loss on consignment, only the cost should be considered.

There are number of reasons why the consignor consigns the goods at invoice price. These are as follows:

i. Sometimes the consignor does not want the consignee to know the actual cost of goods sent to him.

ii. The consignee will not be able to assess the profit earned on consignment and, therefore may not demand a higher commission.

iii. If the consignee knows about actual cost of goods he may resort to some dishonest practices such as buying goods for himself at a lower price and then selling them at a higher price in the market.

iv. It would give a fair idea to the consignee of the minimum price at which he is to sell the goods.

11.2 CALCULATION OF COST AND INVOICE PRICE

Goods can be consigned to the consignee either i.) at cost or ii.) at invoice price

At Cost:

In case of this method the goods are charged to the consignment at cost to the consignor. The Proforma invoice is also prepared at this price. For example, if the goods costing Rs. 10,000 are purchased by A and 80 percent of such goods are sent by him on consignment to Mumbai, Proforma invoice will show the value of goods as Rs. 8,000 and the consignment to Mumbai account will also be charged with this price. The consignee may be given the direction regarding the price at which he should sell the goods.

Example: on 1st April, 2015, 'A' of Mumbai consigned to 'B' of Panaji 200 radio sets at Rs. 300 each. A paid Rs. 500 for insurance and Rs. 1,000 for freight. On 13th April, 2007, B received the consignment and had to pay Rs. 300 as unloading charges and Rs. 150 as dock charges. On the 4th October, 2015, B sent an Account Sales to A informing that till 30th September, 2015, 180 sets were sold at Rs. 400 each and 20 sets at Rs. 350 each. B sent the balance by a demand draft after deducting his commission at 10 percent on sales.

Show necessary Journal entries and relevant ledger accounts in the books of A and B.

Solution:

Books of A

JOURNAL ENTRIES

Date	*Particulars*	*Amount [Dr.]*	*Amount [Cr.]*

2015 April 1	Consignment account Dr. To Goods sent on consignment [Being 200 radio sets sent at Rs. 300 each to B of Panaji]	60,000	60,000
April 1	Consignment A/c Dr. To Bank [Being expenses on consignment insurance Rs. 500 and freight Rs1,000 paid]	1,500	1,500
Oct 4	B Dr. To Consignment A/c [Being sale proceeds of 180 radio set at Rs. 400 each and 20 sets at Rs. 350 each as per Account sales]	79,000	79,000
Oct 4	Consignment A/c Dr. To B [Being expenses incurred by B on consignment – unloading charges Rs. 300 dock charges Rs. 150]	450	450
Oct 4	Consignment A/c Dr. To B [Being commission payable to B- 10% on Rs. 79,000]	7,900	7,900
Oct 4	Consignment A/c Dr. To P/L A/c [Being profit on consignment transferred to profit and loss account]	9,150	9,150
Oct 4	Bank Dr. To B [Being draft received from B for the amount due to us]	70,650	70,650
Oct 4	Goods sent on consignment Dr. To Purchase A/c [Being transfer to purchase account]	60,000	60,000

Ledger accounts

Dr . *CONSIGNMENT ACCOUNT* *Cr.*

Particulars	*Amount [Rs]*	*Particulars*	*Amount [Rs.]*
To Goods sent on consignment	*60,000*	*By B-Sale proceeds of*	
To Bank :		*- 180 set*	
Insurance 500	*1,500*	*@ Rs.400 Rs. 72,000*	
Freight 1,000	*450*	*- 20 set*	*79,000*
To B unloading charges 300	*7,900*	*@ 350 each Rs. 7,000*	
Dock charges 150	*9,150*		
	79,000		*79,000*
To B- Commission			
To Profit and Loss account-Profit		*Total:*	
Total:			

Dr . *Cr.*

Particulars	*Amount [Rs]*	*Particulars*	*Amount [Rs.]*
To consignment A/c	*79,000*	*By consignment A/c*	
		- Expenses 450	
- Sale proceeds		*- Commission 7,900*	*8,350*
		By Bank	*70,650*
	79,000	*Total:*	*79,000*
Total:			

Dr . GOODS SENT ON CONSIGNMENT ACCOUNT Cr.

Particulars	Amount [Rs]	Particulars	Amount [Rs.]
To Purchases	60,000	By Consignment account	60,000

Books of B

JOURNAL ENTRIES

2015	Particulars	Amount [Dr.]	Amount [Cr.]
Oct 4	A Dr.	450	
	To Bank		450
	[Being expenses –unloading charges Rs. 300 and dock charges Rs. 150 paid on behalf of A, the consignor]		
Oct 4	Bank/ debtors Dr.	79,000	
	To A		79,000
	[Being saleproceeds- 180 set at Rs. 400 each and 20 sets at Rs. 350 each]		
Oct 4	A Dr.	7,900	
	To Commission		7,900
	[Being commission due i.e. 10% on sale proceeds of Rs. 79,000]		
Oct 4	A Dr.	70,650	
	To Bank		70,650
	[Being balance sent to A by bank draft]		
	Commission A/c Dr.	7,900	
	To Profit & Loss A/c		7,900
	[Being commission earned transferred to profit and loss account]		

Ledger accounts

Dr . *A* *Cr.*

Particulars	*Amount [Rs]*	*Particulars*	*Amount [Rs.]*
To Bank Expenses	*450*	*By Bank/debtors*	*79,000*
To Commission	*7,900*		
To Bank	*70,650*		
Total:	*79,000*	*Total:*	*79,000*

At Invoice Price:

Sometimes, the consignor sends the goods to the consignee at a price higher than the cost. This is termed as Proforma invoice price. For example, if the goods costing Rs. 10,000 are purchased by A and 80 percent of such goods are sent by him on consignment to Mumbai, Proforma invoice will show the value of goods as Rs. 8,000 and the consignment to Mumbai account will also be charged with this price. If in the above case the goods are consigned at a profit of 25 percent on cost [or 20 percent on invoice price], the consignment account will be charged with Rs. 10,000 [i.e. Rs. 8,000+ Rs. 2,000] for the value of goods sent on consignment. However, in order to find out the profit, at the end of the accounting period, the consignment account will be given credit with the excess price so charged. In this case, the credit to the consignment account will be of Rs. 2,000. Thus, in fact, consignment account has been charged only with the cost [i.e. Rs.10,000 – Rs. 2,000] of the goods sent on consignment as has been done in the first case. Suitable adjustment for profit element included in the stock with the consignee has also to be made.

The relationship between the invoice price [IP] , cost price [CP] and profit can be expressed in the form of an equation as follows:

IP = CP + Profit

Some Cases:

i. ***CP is given and profit is given as a percentage of CP***

Suppose the CP of a product is Rs. 200 and there is 20% profit on cost. The IP will be calculated as follows:

IP = CP + Profit

IP= 200 + [20/100 200]*

IP = 200 + 40

IP = Rs. 240

ii. CP is given and profit is given as a percentage of IP

Suppose CP of a product is Rs. 200 which is involved at 20% profit on IP. IP will be calculated as follows:

Let us assume that the IP is X

IP = CP + Profit

X= 200 + [20/100 X]*

X = 200 + 20/100X

X – 20/100X = 200

80/100 X = 200

X = Rs. 250

*Profit = 20/100 * X= 20/100 * 250 = Rs. 50*

iii. IP is given and profit is given as a percentage of IP

Suppose the IP of a product is Rs. 500 and profit is 25% on IP. The missing figure i.e. CP is worked out as

IP = CP + Profit

*500 = CP + 25/100 * 500*

500 = CP + 125

CP = Rs. 375

iv. IP is given and profit is given as a percentage of CP

Suppose the IP is Rs. 600 and profit is 20% on CP then CP will be calculated as follows:

Let us assume CP to be X

IP = CP + Profit

600 = X +20/100 X

600 = 120/100 X

*X = 600 * 100/120*

X= Rs. 500

*Profit = 20/100 * 500 = Rs. 100*

The following are the advantages of invoicing goods to consignee at a price higher than the cost:

i. The consignor can keep secret from the consignee the profit that he is making on the goods sold, thus reducing the possibility of bringing more competition in the field.

ii. The consignee can be directed to sell the goods at the invoice price only. Thus, he is prevented from charging different prices from different customers.

iii. Control over stock with the consignee becomes slightly easier. The value of stock with the consignee at any time will be the difference between the value of goods sent on consignment and the sales made by him.

11.3 LOADING

The invoice price is obtained by adding a certain amount of profit to the cost price. The amount of profit which is added to the cost in order to arrive at the invoice price is called loading. In other words, loading is the difference between the invoice price and the cost price.

Loading = Invoice Price – Cost Price

11.3.1 ITEMS WHICH INVOLVE LOADING

Loading is usually involved in all such items which are recorded at the invoice price in the consignment account. These items are:

i. Opening stock

ii. Goods sent on consignment

iii. Goods returned by the consignee

iv. Closing stock

You have to compute the loading in respect of all the above items and make necessary adjustments in books of the consignor.

11.3.2 ADJUSTMENT OF LOADING

In consignment account prepared earlier, the goods sent on consignment and the other related items were shown at cost. Hence we had no problem in computing profit. But when the goods sent on consignment and other related items are shown in the consignment account at invoice price , it becomes necessary to adjust the loading in the consignment account so as to bring down the invoice price to the level of cost. if such adjustment is not done, the profit figure will be incorrect. There is also a possibility that the consignment account shows loss because the difference between the selling price and the invoice price is generally small which cannot cover all expenses.

Now take the items involving loading one by one and see how the necessary adjustments are made:

i. Opening stock- openin stock is always shown on the debit side of the consignment account. in case the stock is shown at invoice price, the difference between the invoice price and the cost price of the stock will be shown on the credit side of the consignment account by passing the following journal entry:

Stock Reserve A/c Dr.

n consignment – goods sent on consignment are shown on the debit side of the consignment account. in order to nullify the effect of invoice price, the difference between the invoice price and the cost price in respectof goods sent on consignment will be shown on the credit side of the consignment account by passing the following To Consignment A/c

[Being unloading on opening stock]

ii. Goods sent ojournal entry:

Goods sent on consignment A/c Dr

To Consignment A/c

[Being unloading on closing stock]

iii. Goods returned by the consignee- as the return of goods is shown on the credit side of consignment account, the adjustment for the loading will be made on the debit side of consignment account with the help of the following journal entry:

Consignment A/c Dr

To goods sent on consignment A/c

[Being loading on goods returned]

iv. Closing stock- since closing stock is shown on the credit side of consignment account, the adjustment for the loading will be made on the debit side with the help of the following journal entry

Consignment A/c Dr

To Stock Reserve

[Being unloading on closing stock]

The adjustment entry for loading in the consignment account is made on the opposite side of the original entry. For example the closing stock is shown on the credit side of the consignment account whereas its adjustment is shown on the debit side of the consignment account. This is how the effect of loading in consignment account is neutralised and the invoice price is brought down to the cost level. The adjustment for loading is to be made in the books of the consignor only. The consignee does not record any entry for the items involving loading. Therefore, no adjustment is needed in his book

11.4 ACCOUNTING FOR GOODS SENT AT INVOICE PRICE

The following journal entry is passed in the books in the case of invoice price:

Goods sent on consignment account Dr.

To consignment account

[with the difference between the invoice price and cost price of the goods sent.]

If some goods remain unsold with the consignee, then also, the consignor considers the invoice price, but an adjustment is required to be made at the end of the year to find out profit or loss. The entry will be:

Consignment account Dr.

To stock reserve account

Stock reserve account will be transferred to the consignment account on the credit side at the beginning of the next year.

Example: X consigns to Y goods costing Rs. 2,00,000 at the Proforma invoice price of 25% above cost. At the end of the year, goods of the Proforma invoice price of Rs. 50,000 remained unsold with the consignee and they are valued at Rs. 53,000 for the purpose of stock. Pass the necessary entries in X's books, including those relating to adjustment of Proforma invoice price, for calculating 'profit on consignment for the year'.

Solution:

JOURNAL ENTRIES IN THE BOOKS OF X

Date	*Particulars*	*Amount [Dr.]*	*Amount [Cr.]*
	Consignment A/c Dr.	*2,50,000*	
	To Goods sent on consignment		*2,50,000*
	*[Being goods sent at Proforma invoice price of 25% above cost, i.e. 2,00,000 * 125/100]*		
	Stock on Consignment A/c Dr.	*53,000*	
	To consignment A/c		*53,000*
	[Being stock left unsold at invoice price plus proportionate expenses]		
	Goods sent on consignment A/c Dr.	*50,000*	
	To consignment A/c		*50,000*
	[Being adjustment of goods sent on		

	consignmen at invoice price]		
	Consignment A/c Dr. *To Stock reserve A/c* *[Being adjustment of stock left unsold and credited to consignment account at invoice price, i.e. 50,000*25/125]*	*10,000*	*10,000*
	Goods sent on consignment A/c Dr. *To Purchase A/c* *[Being transfer of goods sent on consignment account]*	*2,00,000*	*2,00,000*

11.5 SUMMARY

Invoice price is the manufacturer's initial charge to the dealer including freight, destination or delivery charges. This price may not reflect the dealer's final cost due to rebates, allowances, discounts and incentive awards the dealer may receive. In order to conceal the actual profit earned on consignment the consignor invoices the goods to the consignee at a price which is higher than the cost. This is called invoice price. The difference between the invoice price and the cost is called loading. This affects four items shown in the consignment account viz. i.) Goods sent on consignment, ii.) Goods returned by the consignee, iii.) Opening consignment stock, iv.) Closing stock. In order to work out the actual profit, the effect of loading of all these items has to be nullified; otherwise the consignment account will show profit which is less than the profit actually earned.

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SELF ASSESMENT QUESTIONS

1. What do you understand by invoice price? Give reason for consignment of goods at the invoice price.

2. What is loading? How do you compute it? Give examples.

3. Name items which are recorded at the invoice price in the consignment account. Give journal entries passed for the adjustment of loading in respect of each item.

UNIT-12 JOINT VENTURE ACCOUNTS

Objectives :

After going through this unit, you must be able to understand:

- The meaning, features and benefits of joint venture;
- The difference among joint venture, consignment, and partnership;
- Process of recording joint venture transactions under different methods; and
- The journal entries and ledger accounts under different methods and the distinctive feature of each of them

Structure :

12.1 MEANING OF JOINT VENTURE

A joint venture is an association of two or more than two persons who have combined for the execution of a specific transaction and to divide the profit or loss thereof in the agreed ratio. It may consist of a joint consignment of goods, an underwriting transaction, a speculation in shares or any other similar form of enterprise. The venture will be over as soon as this transaction is over. It is a temporary partnership between two or more persons confined to a particular venture or piece of business. Persons agreeing to work in a joint venture are called co-venturers or joint-ventureres.

The essential features of a joint venture agreement can be put as follows:

i. There is an agreement between two or more than two persons

ii. The agreement is made for the execution of a specific venture

iii. The profit or loss on account of the venture is shared by the venturers in the agreed ratio. However, in the absence of any agreement between the venturers, the profits and losses are to be shared equally

iv. The agreement regarding the venture is automatically over as soon as the transaction is completed.

v. No specific name of the firm is necessary for a joint venture business.

Benefits of Joint venture:

i. **Sharing of Risk:** The risk of the joint venture transaction is not to be borne only by one person. It is shared in an agreed ratio because profits or losses of the transaction are shared in a predetermined ratio.

ii. **Financial resources:** These are collected by two or more persons in the joint venture transaction. Thus, adequate financial availability is possible to undertake relatively big projects requiring more capital.

iii. **Sufficient experience:** More people can come together in a joint venture business having wide experience in a particular line. Thus, people of different skills and experiencecan combine together to undertake costly and profitable projects and execute them efficiently.

12.2 JOINT VENTURE AND CONSIGNMENT

The difference between Joint venture and Consignment can be put as follows:

i. **Relationship:** Joint venture is a sort of temporary partnership. The relation between the co-venturers is that of partners. However, consignment is a sort of joint relationship in which the consignor is a principal and the consignee is an agent

ii. **Sharing of Profits:** In case of joint venture, the profit or losses are shared by the co- venturers in the agreed ratio. While in case of consignment, consignor and consignee do not share the profits and losses of the business. The consignee simply gets commission as reward for the services rendered by him.

iii. **Contribution of Funds:** In case of joint venture the funds for the venture are provided by the -co venturers, while in case of consignment, the consignee does not provide any funds. All funds are provided by the consignor only

iv. **Risk**: In case of joint venture the business operations are at the risk of all the co-venturers. While in case of consignment, consignee carries on business operations at the risk of the consignor.

v. **Rights**- in case of joint venture, the co- venturers have rights to buy or sell or make payments on account of the joint venture. While in case of consignment, the consignee has to work in accordance with the instructions of his principal i.e. the consignor. The consignee has no independent rights on his own.

12.3 JOINT VENTURE AND PARTNERSHIP

According to the Indian Partnership Act, ‘Partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all’. Thus, both in joint venture and partnership there is some business activity whose profit [or loss] is agreed to be shared by two or more than two persons. As a matter of fact, in law, a joint venture is treated as a partnership. A partnership covers or is meant to cover a long period whereas a joint venture is only for a limited purpose sought to be achieved in a short period. On account of this reason, joint venture is also sometimes termed as a ‘temporary partnership’ or ‘partnership for a specific venture’, or ‘particular partnership’

The points of difference between a joint venture and partnership are as under

i. The scope of joint venture is limited to specific venture; whereas in partnership, the scope is much wider. Partnership is a continuing profit-seeking enterprise, while joint venture is a profit-seeking terminable venture.

ii. Partnership is carried on under a firm’s name, whereas there is no such common firm name in case of a joint-venture.

iii. The persons carrying on business in partnership are called partners, but in joint venture, they are called co-venturers.

iv. Profit or loss is ascertained in partnership on an annual basis, whereas in joint-venture, it is ascertained after the end of the specific venture. Similarly, accounts are prepared annually in partnership, whereas in joint-venture, accounts are prepared after the end of the venture, or if venture continues for a longer period, they can be prepared on an interim basis annually.

v. The doctrine of implied authority is applicable to partners, whereas in joint venture, this doctrine is not applicable to co-venturers.

vi. In joint-venture, the co venturers have freedom to run competitive business independently of the venture but in partnership, partners do not have such unrestricted freedom.

vii. A minor can be admitted to the benefits of a partnership whereas in joint-venture, no such benefits are allowed.

viii. Partnership firms are governed under the provisions of Partnership Act. No such Act is there for joint venture.

12.4 ACCOUNTING TREATMENT

There are three ways in which Joint Venture Account can be kept. They are as follows:

a. **Recording in the Separate Set of Books** Separate set of books for the venture are maintained. This will be necessary when venture is of a large magnitude.

b. **Recording in the books of one co-venturer-** in this case entire work is entrusted to one of the venturers and the rest simply contribute their share of investment and place it at the disposal of the working venture.

c. **Recording in the books all co-venturer-** where venture is not of such magnitude as to warrant a distinct set of books being kept, each venturer will record only such transactions as directly concern him.

12.5 RECORDING IN THE BOOK OF ONE CO-VENTURER

Where work for recording joint venture transactions is entrusted to one of the co-venturers, he is usually allowed an extra remuneration out of the profit for his services.

Following main accounts are maintained by him:

i. Joint Venture Account which shows the amount of Profit or loss made on the venture.

ii. Personal accounts of all other co-venturers.

As the recording of transactions by both is a duplication of effort, it is enough if one of the co-venturers records these transactions. It should be understood that each co-venturer is having his own separate business and their transactions are in addition to what one records in respect of one's independent business.

The Journal entries to be passed in case of this method are given below:

JOURNAL ENTRIES

TRANSACTION	DEBIT	CREDIT
1. When the working partner receives from other - Co Ventures their share of investment 2. When goods are purchased 3. When expenses for the venture are incurred 4. When goods are	Cash/ Bank A/c Joint venture A/c Joint venture A/c Cash or Drs. A/c Joint venture A/c	Venturer's A/c Cash or Crs. A/c Cash A/c Joint venture A/c Commission A/c [later on transferred to his P&L A/c]

sold	Joint venture A/c	P&L A/c
5. When he is allowed an extra commission for his services	Joint venture A/c	Individual accounts of the Co-Venturers
6. The balance of joint venture account will show either a profit or loss i. His own share of profit will be transferred to his P&L A/c ii. The shares of co-ventures will be transferred to their respective personal account iii. The venturer's accounts will then show what is due to them in respect of their investments and their share of profit or loss		

Example: A and B entered into a joint venture agreement to share the profits and losses in the ratio of 2:1. A supplied goods worth Rs. 60,000 to B incurring expenses amounting to Rs. 2,000 for freight and insurance. During transit goods costing Rs. 5,000 became damaged and a sum of Rs. 3,000 was recovered from the insurance company. B reported that 90% of the remaining goods were sold at a profit of 30% of their original cost. Towards the end of the venture, a fire occurred and as a result the balance stock lying unsold with B was damaged. The goods were not insured and B agreed to compensate A by paying in cash 80% of the aggregate of the original cost of such goods plus proportionate expenses incurred by A. Apart from the joint venture share of profit, B was also entitled under the agreement to a commission of 5% of net profits of joint venture after charging such commission. Selling expenses incurred by B totalled Rs. 1,000. B had earlier remitted an advance of Rs. 10,000. B duly paid the balance due to A by draft.

You are required to prepare:

i. *Joint venture account*

ii. *B's account*

Solution:

A's Book

JOINT VENTURE ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Purchases [cost of goods supplied]	*60,000*	*By Bank [insurance claim]*	*3,000*
To Bank [expenses]	*2,000*	*By B [sales]*	*64,350*
To B [expenses]	*1,000*	*By B [agreed value for damaged goods]*	*4,546*
To B[commission 1/21 of 8,896]	*424*		
To Profit transferred to			
Profit & Loss A/c	*5,648*		
B	*2,824*		
Total:	*71,896*	*Total:*	*71,896*

B's Book

JOINT VENTURE ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
*To Joint Venture A/c [sales]**	*64,350*	*By Bank [advance]*	*10,000*
*To Joint Venture A/c [claim portion]***	*4,546*	*By Joint Venture A/c [expenses]*	*1,000*
		To Joint Venture A/c[commission]	*424*
		To Joint Venture A/c [share of profit]	*2,824*
		By Bank [balance received]	*54,648*
Total:	*68,896*	*Total:*	*68,896*

* Computation of sales:

Cost of goods sent	60,000
Less : cost of damaged goods	5,000
	55,000
Cost of goods remaining unsold	5,500
Cost of goods sold	49,500
Profit 30%	14,850
Sales	64,350

** Claim for loss of fire admitted by B

Cost of goods		5,500 Add:
Proportionate expenses [(2,000*5,500)/ 60,000]	183	
		5,683
Less : 20%		1,137
Amount of claim		4,546

12.6 RECORDING IN THE BOOK OF ALL CO-VENTURERS

There are two methods of keeping books:

i. When each party informs the other party regarding transactions made by him on account of joint venture at regular intervals

In this case each party maintains the following accounts:

a. Joint Venture Account: It is similar to an ordinary Profit & Loss Account. It is debited with total purchases and total expenses incurred and credited with the amount of sales and stock in hand. The balance of this account is either a profit or a loss.

b. Personal Account or Accounts of the Co-ventures: This personal account is written as 'Joint Venture with ....Account'. The words 'Joint Venture with.....................' are added before the name of the Venturer, only to distinguish it form other personal accounts of the main business. It is a record of transactions made by the co-venturer on account of joint venture. The account is closed by setting the balance.

The Journal entries to be passed in case of this method are given below:

JOURNAL ENTRIES

TRANSACTION	DEBIT	CREDIT
7. When goods are bought or money is spent on Joint Venture	Joint venture A/c	Seller's A/c or Bank A/c
8. When he receives a report that his co-venturer has bought goods or spent money on the joint venture	Joint venture A/c	Co –venturer's Personal A/c
9. When he sells goods bought on joint venture A/c	Cash A/c or Purchaser A/c	Joint venture A/c
10. When he receives a report that his co-venturer has sold goods bought on joint venture A/c	Co-Venturer's A/c	Joint venture A/c
11. The balance of joint venture A/c will be either profit or loss		
i. For his share of profit	Joint venture A/c	P&L A/c
ii. For his co-venturer's share of profit	Joint venture A/c	Co-Venturer's A/c
In case of loss, entries will be reversed		
12. The personal account of the co-venturer when balanced will show what is due from him or what is due to him		

Example: A and B were partners in a joint venture sharing profits and losses in the proportion of 4/5 and 1/5 respectively. A supplies goods to the value of Rs. 50,000 and incurs expenses amounting to Rs. 5,400. B supplies goods to the value of Rs. 14,000 and his expenses amount to Rs. 800. B sells goods on behalf of the joint venture and realises Rs. 92,000. B is entitled to a commission of 5% on sales. B settles his account by bank draft. Give journal entries and necessary accounts in the books of A.

Solution:

JOURNAL ENTRIES

PARTICULARS	*Dr. Amount*	*Cr. Amount*
Joint venture A/c Dr.	*55,400*	
To Trading A/c		*50,000*
To Bank		*5,400*
[Being goods sent to B to be sold by him on joint account and expenses incurred]		
Joint venture A/c Dr.	*14,800*	
To B		*14,800*
[Being the value of goods supplied and expenses incurred by B on joint account]		
B Dr.	*92,000*	
To Joint venture A/c		*92,000*
[Being sale proceeds on joint account received by B]		
Joint venture A/c Dr.	*4,600*	
To B		*4,600*
[Being the commission due to B on joint venture sales at the rate of 5%]		
Joint venture A/c	*17,200*	*3,440*

Dr.		*13,760*
To B		
To Profit & Loss A/c		
[Being the profit of Rs. 17,200 divided as to 1/5 to B and 4/5 to self-transferred to profit and loss account]	*69,160*	
		69,160
Bank Dr.		
To B		
[Being the bank draft received from B in settlement]		

A's Book

JOINT VENTURE ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Trading A/c [goods]	*50,000*	*By B [sales]*	*92,000*
To Bank [expenses]	*5,400*		
To B			
Goods	*14,000*		
Expenses	*800*		
To B [commission]	*4,600*		
To B [1/5th profit]	*3,440*		
To Profit & Loss A/c			
[4/5th profit]	*13,760*		
Total:	*92,000*	*Total:*	*92,000*

B's Book

JOINT VENTURE ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Joint Venture A/c [sales]	*92,000*	*By Joint venture A/c*	
		Goods	*14,000*
		Expenses	*800*
		By Joint Venture A/c	
		Commission	*4,600*
		Profit	*3,440*
		By Bank [bank draft in settlement]	*69,160*
Total:	*92,000*	*Total:*	*92,000*

ii. When such information is furnished at the completion of the venture. This is popularly known as '**Memorandum Method**'

12.7 MEMORANDUM JOINT VENTURE ACCOUNT METHOD

The following are the salient features of this method:

i. Each party will maintain only ONE account in his books. This account will be personal account of other parties. It may be very carefully noted that even if there are more than two ventures only one personal account is to be opened in each party's books. For example, if A, B, and C have entered into a joint venture. A will open one personal account of B and C in his book and not separate accounts. Similarly B will open joint account of A and C and C will maintain joint account of A and B

ii. Each party will record only such transactions as entered by him on joint venture account e.g. if goods are purchased by A, it will be recorded in A's books and not in the books of B and C

iii. In order to find out profit or loss made on the venture a 'Memorandum Joint Venture Account' will be opened. It is merely a combination of personal account i.e. debit side of personal accounts is posted on the debit side of memorandum Joint Venture Account and credit side of personal accounts is posted on the credit side of Memorandum Joint Venture Account . However, such transactions which will not affect profit or loss on the venture e.g. receiving or sending of cash by one venture from or to another will not be entered in his account.

Example: A and B entered into a joint venture as dealers in land with effect from 1st July, 2015. On the same day A advanced Rs. 90,000 and a plot of land measuring 9,000 square yards, was purchased with this money. It was decided to sell the land in smaller plots and a plan was got prepared at a cost of Rs. 1,000 paid by B. In the said plan 1/3 of the total area of the land was left over for public roads and the remaining land was divided into 6 plots of equal size. On 1st October, 2015 two of the plots were sold at Rs. 30 per square yard, the buyer deducting Rs. 1,000 per plot for stamp duty and registration expenses agreed to be borne by the sellers. The remaining plots were sold at a net price of Rs. 25 per square yard on 1st December, 2015. The sale proceeds of all the plots were received by A. After charging interest at 6% p.a. on the investments of A [allowing for money received by him] and allowing 1% on the net sale proceeds of plots as commission to B, the net profit of the joint venture is to be shared in proportion of ¾ to A and ¼ to B.

Draw up the Memorandum Joint Venture and personal account in the books of A and B showing the balance payable to one and the other. Assume joint venture was completed on December 1.

Solution:

A's Book

JOINT VENTURE WITH B ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Bank [advance]	*90,000.00*	*By Bank [sale]*	
*To interest**	*1,670.00*	*2000* 30= 60,000*	
To P&L A/c [share of profit]	*47,812.00*	*Less @Rs.1,000 per plot 2,000*	*58,000.00*
To Bank [final settlement]	*18,517.50*	*By bank [sale] 4,000* 25*	*~~1,00,000~~.00*
Total:	*1,58,000.00*	*Total:*	*1,58,000.00*

* Interest receivable by A:

July 1, 2005 to Dec 1, 2005

Rs. 90,000 * 6/100 * 5/12 = Rs. 2,250

Interest payable by A:

Oct 1, 2005 to Dec 1, 2005

Rs. 58,000 * 6/100 * 2/12 = Rs. 580

Net interest receivable by A = Rs. 1,670

B's Book

JOINT VENTURE WITH A ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Bank [Expense]	*1,000.00*	*By Bank [final settlement]*	*18,517.50*
To commission	*1,580.00*		
To P&L A/c [share of profit]	*15,937.50*		
Total:	*18,517.50*	*Total:*	*18,517.50*

MEMORANDUM JOINT VENTURE ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Purchase [A]	*90,000.00*	*By Sales*	*1, 58,000.00*
To interest [A]	*1,670.00*		
To Expenses [B]	*1,000.00*		
To Commission [B]	*1,580.00*		
To Profit			
A 47,812.50			
B 15,937.50	*63,750.00*		
Total:	*1,58,000.00*	*Total:*	*1,58,000.00*

12.8 SEPARATE SET OF BOOKS

When venturers agree to keep separate set of books for recording the transactions relating to joint venture it takes the form of an ordinary accounting system in a business. A full double entry system is adopted for this purpose as in the case of any other business. Where a complete set of books are maintained for the joint venture, following accounts are opened:

i. Joint Bank Account

ii. Joint Venture Account

iii. Personal accounts of each venturer

In this method parties first pay their contribution to joint funds in the joint bank account and their payments on joint account are made out of joint bank account.

Joint venture account is of the nature of an ordinary trading and profit & loss account. It is debited with goods purchased and expenses incurred while credited with the sales made. Its balance shows the profit or loss incurred on the joint venture.

Personal account of each venturer is also opened. It is credited with the amount of contribution made by him to the joint funds and his share of profit [and debited in case of loss]

JOURNAL ENTRIES

TRANSACTION	DEBIT	CREDIT
13. When ventures contribute cash to the joint funds	Joint bank A/c [with total amt]	Venturer's A/c [with individual contribution separately]
14. When amount is spent on account of expenses, or for purchasing goods for the venture	Joint venture A/c	Joint bank A/c
15. If any expenses are paid by the ventures	Joint venture A/c	Venturer's A/c
16. For sales		
iii. Cash	Joint bank A/c	Joint venture A/c
iv. credit	Sundry Drs. A/c	Joint venture A/c
17. If stock is taken by a venture	Venturer's A/c	Joint venture A/c
18. If any stock remains unsold	Joint Venture stock A/c	Joint venture A/c
19. Balance of the joint venture A/c will be either profit or loss		
i. If profit	Joint venture A/c	Venturer's A/c
ii. If loss	Venturer's A/c	Joint venture A/c
20. Joint bank account and personal account of venturers will be automatically closed by introduction or withdrawal of cash		

Example: Prakash and Suresh doing business separately as building contractors, undertake jointly to construct a building for a newly started Joint Stock Company for a contract price of Rs. 1,00,000 payable as to Rs. 80,000 by instalment in cash and Rs. 20,000 in fully paid shares of the company. A Bank Account is opened in their joint names, Prakash paying in Rs. 50,000 and Suresh Rs. 25,000. They are to share profit or loss in the proportion of 2/3 and 1/3 respectively. Their transactions were as follows:

	Rs.
Paid wages	*30,000*
Bought materials	*40,000*
Material supplied by Prakash from his stock	*5,000*
Material supplied by Suresh from his stock	*4,000*
Architect's fees paid by Prakash	*2,000*

The contract was completed and price duly received. The Joint Venture was closed by Prakash taking up all the shares of the Company at an agreed valuation of Rs. 16,000.

Prepare the Joint Venture Account, showing profit or loss, and the accounts of Prakash and Suresh showing the final distribution.

Solution:

JOINT VENTURE ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Joint Bank A/c [wages]	*30,0000*	*By Joint Bank A/c*	*80,000*
To Joint Bank A/c [materials]	*40,000*	*By Prakash [shares]*	*16,000*
To Prakash [materials]	*5,000*		
To Suresh [materials]	*4,000*		
To Prakash [architect's fees]	*2,000*		
To Profit Prakas 10,000 Suresh 5,000	*15,000*		
Total:	*96,000*		96,000.00

JOINT BANK ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Prakash	*50,000.00*	*By Joint Venture A/c*	*30,000*
To Suresh	*25,000.00*	*By Joint Venture A/c*	*40,000*
To Joint Venture A/c	*80,000.00*	*By Prakash*	*51,000*
		By Suresh	*34,000*
Total:	*1,55,000.00*	*Total:*	*1,55,000.00*

PRAKASH ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Joint Venture A/c[shares]	*16,000*	*By Joint Bank A/c*	*50,000*
To Joint Bank A/c	*51,000*	*By Joint Venture A/c [materials]*	*5,000*
		By Joint Venture A/c [architect fees]	*2,000*
		By Joint Venture A/c [Profit]	*10,000*
Total:	*67,000*	*Total:*	*67,000*

SURESH ACCOUNT

Dr. Cr.

Particular	*Rs.*	*Particulars*	*Rs.*
To Joint Bank A/c	*34,000*	*By Joint Bank A/c*	*25,000*
		By Joint Venture A/c	*4,000*
		By Joint Venture A/c [Profit]	*5,000*
Total:	*34,000*	*Total:*	*34,000*

12.9 SUMMARY

Joint venture is a temporary partnership between two or more persons confined to a particular venture. The venturers agree to share profits or losses in a particular ratio. If there is no agreement, it is assumed to be equal.

Consignment and joint venture are different. In consignment, the goods are sold by the consignee for a commission on account and at the risk of the consignor. On the other hand, in a joint venture, goods are purchased and sold at the joint risk of two or more persons.

Joint venture and partnership are not one and the same thing. Partnership is a continuing profit-seeking enterprise while joint-venture is a profit-seeking terminable venture.

The three ways of keeping joint venture accounts are as follows:

i. When separate set of books are kept

ii. When transactions are recorded by all the venturers

iii. Memorandum Joint Venture method

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SELF ASSESMENT QUESTION

1. Define Joint Venture. State its features.

2. Distinguish between Joint Venture and partnership.

3. Describe briefly the different methods of recording transactions of joint venture.

4. Distinguish between Joint Venture and Consignment.

Uttar Pradesh Rajarshi Tandon Open University

Bachelor of BusinessAdministration

BBA-106

Financial Accounting

BLOCK

4

ACCOUNTS FROM INCOMPLETE RECORDS

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UNIT–13 SELF- BALANCING SYSTEM

Objectives :

After studying the chapter, you will be able to:

- Meaning of Self- Balancing System
- Sub-division of ledger
- Familiar with the three ledgers are made in self balancing system
- advantages and disadvantages of self- balancing system
- Sectional balancing and ruling of subsidiary books.

Structure :

13.1 Introduction

13.2 Self Balancing System

13.3 Sub-division of ledger

13.4 Procedure of Self-Balancing

13.4.1 Self – balancing the debtors ledger

13.4.2 Self- balancing the general ledger,

13.5 Advantages of self- balancing system

13.6 Sectional balancing System

13.7 Ruling of subsidiary books

13.8 Summary

13.9 Key Words

13.10 Self-Assessment Questions

13.11 Further Readings

13.1 INTRODUCTION

A self balancing ledger system implies a system of ledger keeping which classifies ledgers as per nature of transactions namely Sales Ledger, Bought Ledger, General Ledger etc. and also make them to balance independently. In order to make each ledger self-balancing, an extra account called General Ledger Adjustment Account is opened in each of the sales ledger and bought ledger.

13.2 SELF BALANCING SYSTEM

A System whereby separate trial balance can be taken out from each ledger is termed as self-balancing system. In other words, self-Balancing is a system that facilitates in balancing each ledger individually without the help of other ledgers. Under this system, each ledger is maintained in such a manner as to contain all the materials required for preparing a trial balance separately for each ledger without the help of other ledgers.

NEED FOR SELF BALANCING SYSTEM

When a business is large a number of real and impersonal accounts not only increase abnormally but personal accounts in proportion to real and nominal accounts also enhance considerable. In such a cares, a self balancing system has been evolved to facilitate the detection of errors. Under this system, the ledgers are devised in such a way that (When balances are extracted) a separate trail balance can be prepared from each ledger.

13.3 SUB DIVISION OF LEDGER

In a big business, the number of accounts is numerous and it is found essential to maintain a separate ledger for customers, suppliers and for others usually, the following types of ledgers are maintained in such big business concerns.

1. Personal Ledger
2. General Ledger or Nominal Ledger

1. Personal Ledger

The ledger, which keeps the accounts of persons from credit, it called personal ledger. It is classified in to two categories –

a) Creditors ledger or Purchases ledger

b) Debtors ledger or Sales ledger balancing the system is known is sectional balancing ledger system.

a) CREDITOR'S LEDGER OR PURCHASES LEDGER

The term 'trade creditor's ignifies a credit supplier from whom purchase of goods is made. This ledger is kept for recording the personal accounts of trade creditors only for example if Mr. Gyan who traders in medicine, Purchases, Furniture from, the latter is non-trade creditor. Hence, Mrs. Ananya is placed in the general ledger.

In credito'r ledgers only those business person's accounts are opened from whom goods (in which a buyer deals) are purchased on credit in the above example if medicine is purchased fromMrs. Ananya , her account will be opened in this ledger and goods account will be opened in the general ledger creditors ledger is also known as bought ledger or supplier's ledger.

b) DEBTORS LEDGER OR LALES LEDGER

The term 'Trade Debtors' signifies a credit customer to whom sale is made of goods in which a seller trades. This ledger is kept for recording the personal accounts of trade debtors only and not of any other debtors. For example, if Mr. Gyan trade in Medicine and sells Furniture toMrs. Ananya on credit, Mrs. Ananya is a non-trade debtor. Hence, Mrs. Ananya is placed in the general ledger.

In debtors ledger, only those businessmen's accounts are opened to whom goods (in which a seller trades) are sold on credit. In the above example, if medicine is sold to MrGyan , Gyan's account is opened in Debtors ledger and goods account is opened in general ledger. Debtors ledger is also known as sales ledger or customers ledger.

2. GENERAL LEDGER OR NOMINAL LEDGER

This is the main ledger which contains the rest of the accounts. This ledger usually contains all real and nominal accounts, capital and drawing accounts, and accounts of such persons to whom loan is given or from whom loan is taken. This ledger is also known as nominal ledger or main ledger or private ledger.

When all three important ledgers are made self balancing the system is called the self balancing ledger system. But if one or two of those ledgers alone are made self balancing, the system is known as sectional balancing ledger system.

13.4 PROCEDURE OF SELF-BALANCING

If at last two ledger in existence, it is natural that they will not balance automatically because the congaing one-sided balances for instance, debtors ledger will have debit balances and creditors ledger will have credit balances. These ledgers can be made self-balancing by means of control or total or aggregate accounts.

Control account is an extra account inserted at the back of the ledger to complete the double entry of the ledger and thus to make it self-balancing the following control or adjustment accounts are opened in various ledgers:

1. Sales ledger adjustment account and bought ledger adjustment account at the end of general ledger.
2. General ledger adjustment account at the end of bought ledger and sales ledger.

Items are posted to the ledger as usual but the periodical totals are posted on the opposite side of control account. At the end of the period, the balance on the control account will be equal and opposite to the total of balances on the ledger accounts. Thus the double entry of the ledger becomes complete and enables the preparation of the trail balance from each ledger.

The following Illustration is show the working of this system.

ILLUSTRATION-1

From the following particulars, show the various account in the sales ledger which is kept on Self-Balancing System and prepare the Trial Balance:-

	Sales ₹	**Cash Received ₹**	**Discount allowed ₹**	**Bill receivable Received ₹**	**Goods returned ₹**
A	21440	17120	480	2000	560
B	9880	7320	280	1200	-
C	8930	6750	150	1000	200
D	12620	9500	100	2400	-
E	7070	6400	270	-	-
F	9526	7000	326	-	800

Solution

Debtors Ledger

A's Account

Dr. Cr.

Date	**Particulars**	**Amount (₹)**	**Date**	**Particulars**	**Amount (₹)**
	Sales	21440		Cash	17120
				Discount Allowed	480
				Bills receivable	2000
				Return Inwards	560
				By Balance c/d	1280
		21440			21440

B's Account

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	Sales	9880		Cash	7320
				Discount Allowed	280
				Bills receivable	1200
				By Balance c/d	1080
		9880			**9880**

C's Account

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	Sales	8930		Cash	6750
				Discount Allowed	150
				Bills receivable	1000
				Return Inwards	200
				By Balance c/d	830
		8930			**8930**

D's Account

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	Sales	12620		Cash	9500
				Discount Allowed	100
				Bills receivable	2400
				By Balance c/d	620
		12620			**12620**

E's Account

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	Sales	7070		Cash	6400
				Discount Allowed	270
				By Balance c/d	400
		7070			**7070**

F's Account

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	Sales	9526		Cash	7000
				Discount	326
				Return Inwards	800
				By Balance c/d	1400
		9526			**9526**

General Ledger Adjustment Account

Dr. Cr.

Date	Particulars	Amounts (₹)	Date	Particulars	Amount (₹)
	Sales ledger adjustment Account:			Sales ledger adjustment Account:	
	Cash	54090		Sales	69466
	Discount	1606			
	Bills Receivable	6600			
	Return Inward	1560			
	Balance c/d	5610			
		69466			69466

Trial Balance

Date	Particulars	Dabit (₹)	Credit (₹)
	A	1280	
	B	1080	
	C	830	
	D	620	
	E	400	
	F	1400	
	General ledger adjustment account		5610
		5610	5610

13.4.1 SELF-BALANCING THE DEBTORS LEDGER

The personal accounts of the trade customers only are included in the debtors ledger. However, the sales account is not kept in this ledger. Debtors ledger receives debits when credit sales are effected, bills receivable dishonored and interest/expenses are charged to the customers. It receives credit when cash is received from customers, bill receivables received good returned by the customers and bad debts written off. Control account opened in the debtors ledger is popularly known as general ledger adjustment account in debtors ledger is popularly known as general ledger adjustment account in debtors ledger, corresponding control account opened in the general ledger is Popularly known as debtors ledger adjustment account in general ledger. The following entries are made to complete the double entry of sales ledger.

1. Debtors ledger adjustment A/c Dr. (In general ledger)

   To General ledger adjustment A/c (In Debtors ledger)

(Recording credit sales, B/R dishonored, charges interest etc. Devid on customers)

2. General ledger adjustment A/c Dr. (In Debtors ledger)

   To Debtors ledger adjustment A/c (In general ledger)

(Recording cash received, B/R received, discount allowed, return inwards and bad debts written off)

A format of debtors ledger is given below

IN DEBTORS LEDGER

General Ledger Adjustment Account

Dr. Cr.

Date	Particulars	Amounts (₹)	Date	Particulars	Amounts (₹)
	Debtors ledger adjustment A/c			By Balance b/d	xxxx
	(in general ledger):			Debtors ledger Adjustment A/c	
				(in general ledger)	
	Cash received	xxxx			
	Discount	xxxx		Sales	xxxx
	Bills receivable	xxxx		Cheques	xxxx

	Allowance to debtors Return inward Bad debts Bank (Cheque received) Transfer balance c/d	xxxx xxxx xxxx xxxx xxxx		dishonored B/R dishonored Bills renewed Noting Charges Interest Charged Expenses charged Refund to debtors Discount Allowed	xxxx xxxx xxxx xxxx xxxx xxxx xxxx
		xxxx			xxxx

Illustration -2

The following details are extracted from the book of Sanskriti Ltd. For the year pending Dec. 31, 2012.

Date	Particulars	Amounts (₹)
1 Jan. 2016	Debtors ledger balances total	40,000
	Provision for doubtful debts	2,000
Dec. 31, 2016	Sales	90,000
	Return from customers	800
	Cheques received from customers	80,000
	Cheques dishonored	300
	Bills accepted by customers	2,700
	Bills dishonored	400
	Bad debts written off	1,600
	Interest on customers overdue accounts	100
	Carriage charged to customers	200
	Cash discount allowed	1,800
	Bad debts previously written off received	300

Prepare the debtors ledger adjustment account as it will appeare in the general ledger.

Solution

In General Ledger

Debtors Ledger Adjustment Account

Dr. Cr.

Date	Particulars	Amounts (₹)	Date	Particulars	Amounts (₹)
	To Balance b/d	40,000		**General ledger Adjustment A/c (in debtors ledger):**	
	General Ledger Adjustment A/c				
	Sales	90,000		Return inward	800
	Cheques dishonored	300		Bank chq. received	80,000
	Bill dishonored	400		Bills receivable	2,700
	Interest	100		Bad debts	1,600
	Carriage	200		Discount allowed	1,800
				By Balance c/d	44,100
		1,31,000			**1,31,000**

Note: Provision for doubtful debts account and bad debts previously written off recovered will not appear in debtors ledger adjustment account.

13.4.2 SELF-BALANCING THE GENERAL LEDGER

The ledger which contains the real and nominal account is known as general ledger. It is also known as the main ledger.

All transaction which do not involve personal accounts find their complete posting in general ledger for instance, rent paid ` 5000 both rent account and cash account exist in general ledger. Hence, the double entry of such transactions is already complete in the general ledger.

However, all transactions which involve personal accounts find co responding debit or credit either in debtors ledger or creditors ledger.

Example – 1

Credit sale of ` 5,000.

Debit appears (Personal A/c of the customer) in the debtors ledger and credit appears (Sales A/c) in the general ledger.

Example – 2

Credit purchase of ` 1,000.

Debit appears (purchase A/c) in the general ledger and credit appears (Personal A/c of the supplier) in the creditor ledger.

The double entry of the above transactions in the general ledger can be completed by incorporating two control accounts at the end of the general ledger such accounts are as follows.

1. **Debtors ledger Adjustment account**

   It will result in completing double entry relating to transaction with the customers or trade debtors.

2. **Creditors ledger Adjustment account**

   It will result in completing double entry relating to transactions with the suppliers or trade creditors.

While sales ledger adjustment account is the total account with 'aggregate figures' if all the trade debtors i.e. total debtors account, Purchase ledger adjustment Account is the total account written with 'aggregate figures' of all the trade creditors i.e. total creditors account.

Format of debtors ledger adjustment account

IN GENERAL LEDGER

Debtors Ledger Adjustment Account

Dr. Cr.

Date	**Particulars**	**Amounts (`)**	**Date**	**Particulars**	**Amounts (`)**
	To Balance b/d	xxxx		**General ledger Adjustment A/c** (in debtors ledger):	xxxx
	General ledger Adjustment A/c (in debtors ledger)	xxxx		Cash Received	xxxx
	Sales	xxxx		Discount Allowed	xxxx
	Cheques dishonored	xxxx		B/R	xxxx
	B/R dishonored	xxxx		Return inwards	xxxx
	Bills renewal	xxxx		Allowances	xxxx
	Noting charges	xxxx		Bad Debts	xxxx
		xxxx		Bank (Cheque	xxxx

	Interest Charged Expenses Charged Refund to debtors Discount allowed	xxxx xxxx		received) Transfer By Balance c/d	xxxx
		Xxxx			**xxxx**

IN GENERAL LEDGER

Creditors Ledger Adjustment Account

Dr. Cr.

Date	**Particulars**	**Amounts (`)**	**Date**	**Particulars**	**Amounts (`)**
	General ledger adjustment A/c (in creditors ledger): Cash Paid Discounts Bills payable Return outwards Allowances Transfer Balance c/d	xxxx xxxx xxxx xxxx xxxx xxxx xxxx		By Balance b/d **General ledger Adjustment A/c** (in creditors ledger): Purchases B/R dishonored Noting Charges Interest Payable Carriage Charged Expenses Payable Refunds to creditors Discounts disallowed Cheque dishonored	xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx
		Xxxx			**xxxx**

ILLUSTRATION:

From the following particulars, write up the necessary adjustment account as they would appear in the general ledger.

Debtors balance in general ledger adjustment A/c	60,500
Creditors balance in general Ledger Adjustment A/c	38,500
Credit sales during the year	40,300
Cash sales during the year	12,800
Cash Purchase during the year	16,390
Credit Purchase during the year	26,400
Credit paid off during the year	32,500
Received through bank from debtors	48,200
Discount allowed to the business	376
Discount allowed by the business	450
Return inwards	1,226
Return outwards	876
Accepted bills payable during the year	3,200
Accepted bill receivable during the year	4,800
Bills receivable dishonored	200
Interest charged for dishonored bill	20
Trade discount during the year	974
Bad Debt	374
Transfer from one ledger loon other	196

Solution

IN GENERAL LEDGER

Debtors Ledger Adjustment Account

Dr. Cr.

Date	Particulars	Amounts (₹)	Date	Particulars	Amounts (₹)
	To Balance b/d **General Ledger**	60,500		**General Ledger Adjustment Ledger):**	

	Adjustment A/c (in debtors Ledger)			Cash received	48,200
				Discount	450
	Credit Sales	40,300		Return inwards	1,226
	Bills receivable			Bills receivable	4,800
	Dishonoured	200		Bad debts	374
	Interest charged	20		Transfers	196
				By Balance c/d	45,774
		1,01,020			**1,01,020**

IN GENERAL LEDGER

Creditors Ledger Adjustment Account

Dr. Cr.

Date	Particulars	Amounts (₹)	Date	Particulars	Amounts (₹)
	General Ledger Adjustment A/c (in creditors Ledger)			**By Balance b/d**	38,500
				General Ledger adjustment A/c (in creditors ledger):	
	Cash Paid	32,500		Credit purchases	26,400
	Discount	376			
	Return outwards	896			
	Bill Payable	3,200			
	Transfers	196			
	Balance c/d	27,752			
		64,900			**64,900**

Notes:

- The amount of cash purchases and cash sales are not posted to any individual creditor or debtors account. Hence, such amount will not be entered in adjustment account.
- For trade discount, no entry is passed in the books because the amount of sales is always taken after deducting the trade discount from the gross figure.

13.5 ADVANTAGES OF SELF BALANCING SYSTEM

There are so many advantages of self Balancing System the main advantages are as followers:

- **Preparation of interim accounts**

It enables preparation of interim account without personal legers having to be balanced.

- **Fixation of responsibility of Ledger keeper**

Self balancing system fixes the responsibility of the ledger keeper, as to the balancing of the ledger under his/her charge and the person responsible for the mistake can be called upon to work overtime to locate it. Errors are localized.

- **Availability of Total figures**

The figures of total debtors or creditors is readily available.

- **Secrecy**

Where it is desired not to revel the content of the private ledger to the clerical staff, the balances on this ledger can be directly incorporated in total figure in the trial balance.

- **Arithmetical accuracy**

Arithmetical accuracy of each ledger can be proved independently.

- **Internal check**

It is instrumental is strengthening the internal check.

13.6 SECTIONAL BALANCING SYSETM

Under Sectional Balancing System only general ledger is self-balanced, not like self-balancing ledger where all ledgers are self-balanced. That is why, for each individual purchase and sales ledger a control account is opened in the general ledger which are known as Total Creditors Account or Purchase Ledger Control Account and Total Debtors Account or Sales Ledger Control Account. The balance of total creditors account must be equal to the balance shown by the individual balances of creditors account and if they agree it may be assumed that purchase ledger are correctly made. Similarly, the balance of total debtors must be equal to the balance shown by the individual balances of customers account and if both of them are agreed, it may be assumed that sales ledger is correctly posted. However, the total of Sales Day Book will be debited to Total Debtors Account and in the general ledger sales account is credited. All the credit items (viz, cash received from Debtors, Bad Debts, Returns inwards, Bills Receivable etc.) are credited to total debtors account and corresponding accounts are debited. In case of Total Creditors Account, however, all the debit items (viz, cash paid to creditors, Discount Received, Returns Outward, Bills Payable etc.) are debited to Total Creditor Account and corresponding accounts are credited.

A really simple way to prove the accuracy of say, the sales ledger would be to maintain a total Debtors account in the General ledger. It would mean that whereas account of individual customer would be maintained in the sales ledger, in the General ledger the Total Debtors account would be posted by the (Monthly) total of various transaction with total credit sales, total amount received from credit customers, total discount allowed to them, total returns inwards, total bills receivable received etc. the balance in the total Debtors Account should be equal to the total of balance shown by the accounts of in visual customers. If it is so the total Debtors Account as well as in visual customers' account may be taken as correct. A difference would show that there is somewhere.

In the same way, the accuracy of in Vidal supplier account may be cheeked by comparing total of their balances with the balance in the total creditors Account.

The double entry would be complete in the General ledger itself for instance, for credit sales– **Total Debtors Account** would be debited and Sales account credited for goods returned to suppliers **Total creditors Account** would be debited and Return outward Account credited.

The Total accounts are also known as adjustment accounts or control accounts since they prove the ac curacy of the subsidiary (sales) ledgers.

To sum up, under sectional balancing system, only the total account for each of the subsidiary ledgers is opened in the general ledger and no control/adjustment account/self Balancing account is opened in subsidiary ledger.

13.7 RULING OF SUBSIDIARY BOOK

Whenever there are several sales or Purchase ledger in use, various books of oriental entry, e.g. Purchases Books Sales Books, Cash Book and Journal are suitably ruled in a manner that they readily show the monthly total of the transactions posted in various ledgers, on the basis of which the self Balancing entries, can be recorded.

13.8 SUMMARY

After the transactions, being recorded in the journal, are classified in the ledger. A small enterprise normally has less number of accounts are therefore can maintain all the accounts in one ledger alone. However, in case of a big enterprise, the number of accounts are large and, therefore, it becomes inconvenient to maintain all accounts into one ledger alone. Hence in such a condition the ledger is sub-divided into the following three ledgers: 1- Debtors or sales ledger 2- Creditors or bought or purchases ledger and 3- General or nominal ledger.

13.9 KEY WORDS

Self- Balancing System:- A system whereby separate trial balance can be taken out from each ledger.

General Ledger:- The main ledger which usually contains all real and nominal accounts, capital and drawing accounts and accounts of such persons to whom loan is given or from whom loan is taken.

Creditors Ledger: - A ledger which contains the personal accounts of trade creditors only.

Debtors Ledger: - A ledger which is kept for recording the personal accounts of trade debtors only and not of any other debtors.

Personal Ledger: - The ledger which keeps the account of persons from whom goods are purchased or to whom goods are sold on credit.

13.10 SELF-ASSESSMENT QUESTIONS

1. What do you mean by self-balancing system? How ledgers are made self-balancing?
2. Write the advantages of self-balancing system.
3. What is sectional balancing system?
4. Under the self-balancing system, how is a ledger divided?

13.11 FURTHER READINGS

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UNIT–14 ACCOUNTS FROM INCOMPLETE RECORDS

Objectives :

After studying the chapter, you will be able to:

- state the meaning of incomplete records;
- distinguish between Balance Sheet and Statement of Affairs;
- calculate Profit or Loss using the Statement of Affairs Method;
- prepare Profit and Loss Account and the Balance Sheet;

Structure :

14.1 INTRODUCTION

Incomplete records are intended to signify any accounting records which fall short of complete double entry. There are varying degrees of incompleteness and the procedure to be adopted in order to prepare final accounts must depend upon the nature of the records and data available. Incomplete record is also known as Single Entry System of Accounting. In this chapter we will learn how an accountant prepares financial statements of those organizations which are not keeping up proper double entry book-keeping system of accounting

14.2 SINGLE ENTRY SYSTEM

Incomplete records means the state of affairs which exists when there is lacking some or the entire prime accounting information from which in the normal way the books of a business are written up and final accounts prepared. It is not, for instance, applicable where an adequate system exists for supplying the accountant with information in a suitable form for writing up his client's books or otherwise collating the essential information and subsequently preparing final accounts.

Definition

Single entry system may be defined as that system of book keeping in which only records of cash and personal accounts are maintained and no set rules are followed. This system is also called as incomplete double entry system or accounts from incomplete records.

Accountants, in general, feel reluctant to use the phrase "Single Entry System," because strictly speaking there exists no such system. The so-called system is developed by certain business entities for their convenience without adhering to the rules of double entry system. Under this system only cash book and personal accounts are maintained, but the most essentially needed subsidiary books – backbone of the double entry system– are not maintained. To put it in a nutshell, this system may be termed as an incomplete double entry system. **Kohler defines** it 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."

14.3 SALIENT FEATURES OF INCOMPLETE RECORDS SYSTEM

In complete records may be due to partial recording of transactions as is the case with small shopkeepers such as grocers and vendors. In case of large sized organisations, the accounting records may be rendered to the state of incompleteness due to natural calamity, theft or fire. The features of incomplete records are as under:

- It is an unsystematic method of recording transactions.
- Generally, records for cash transactions and personal accounts are properly maintained and there is no information regarding revenue and/or gains, expenses and/or losses, assets and liabilities.
- Personal transactions of owners may also be recorded in the cash book.
- Different organisations maintain records according to their convenience and needs, and their accounts are not comparable due to lack of uniformity.

- To ascertain profit or loss or for obtaining any other information, necessary figures can be collected only from the original vouchers such as sales invoice or purchase invoice, etc. Thus, dependence on original vouchers is inevitable.

- The profit or loss for the year cannot be ascertained under this system with high degree of accuracy as only an estimate of the profit earned or loss incurred can be made. The balance sheet also may not reflect the complete and true position of assets and liabilities.

14.4 REASONS OF INCOMPLETENESS AND ITS LIMITATIONS

It is observed, that many businessmen keep incomplete records because of the following reasons:

- This system can be adopted by people who do not have the proper knowledge of accounting principles;

- It is an inexpensive mode of maintaining records. Cost involved is low as specialised accountants are not appointed by the organisations;

- Time consumed in maintaining records is less as only a few books are maintained;

- It is a convenient mode of maintaining records as the owner may record only important transactions according to the need of the business.

However, the mechanism of incomplete records suffers from a number of limitations. This is due to the basic nature of this mechanism. Broadly speaking, unless a systematic approach to maintenance of records is followed, reliable financial statements cannot be prepared.

Limitations of single entry system are as follows:

- As double entry system is not followed, a trialbalance cannot be prepared and accuracy of accounts cannot be ensured.

- Correct ascertainment and evaluation of financial result of business operations cannot be made.

- Analysis of profitability, liquidity and solvency of the business cannot be done. This may cause a problem in raising funds from outsiders and planning future business activities.

- The owners face great difficulty in filing an insurance claim with an insurance company in case of loss of inventory by fire or theft.

- It becomes difficult to convince the income tax authorities about the reliability of the computed income.

Distinction between double entry system and incomplete records system

Basis of distinction	Double entry system	Incomplete records system
1. Assumptions and principles	It is based on certain assumptions and principles	It is not based on certain assumptions and principles
2. Both aspects of all transactions	Both the aspects of all transactions are recorded	Both the aspects of all transactions are not recorded
3. Nature of accounts maintained	All types of accounts – personal, real and nominal – are maintained	Usually cash and personal accounts are maintained
4. Trial Balance	Arithmetical accuracy of the records can be checked by preparing a trial balance	Arithmetical accuracy of the records cannot be checked since trial balance cannot be prepared
5. Determination of true profit or loss	True profits or losses can be determined by preparing trading and profit and loss account	Only estimated profit or losses can be determined since trading and profit and loss account cannot be prepared.
6. Financial Position	True financial position can be known by preparing a balance sheet	Only estimated financial position can be known on the basis of statement of affairs.
7. Adjustments	All types of adjustments made while preparing financial accounts.	No special attention is given to adjustments.

8. Utility	It is used by all types of traders.	It is used only by small traders.
9. Recognition	Records maintained according to this system are recognised by the government	Records maintained according to this system are not recognised by the government

14.5 METHOD OF ASCERTAINMENT OF PROFIT OR LOSS

Every business entity wants to know its financial position and operating results for a specific period. Under this system, as no records are maintained in accordance with standardised accounting principles, it is not possible to prepare final accounts – Trading and Profit and Loss Account to furnish operating results and Balance Sheet to ascertain its financial position.

For this system, generally, the following two methods are employed to ascertain profit /loss.

1. Statement of Affairs Method (or) Net Worth Method
2. Conversion Method

14.5.1 STATEMENT OF AFFAIRS METHOD (OR) NET WORTH METHOD

Meaning

A statement that shows items of different assets and liabilities is referred to as the Statement of Affairs.

i. This is prepared to compute the Capital (difference between Total Assets and Total Liabilities) in the beginning and at the end of the accounting period.

ii. This is similar to the Balance Sheet.

iii. Sources of accounting under this method:

   a. Cash book

   b. Bank pass book

   c. Debtors and creditors personal ledger

d. List of fixed assets (not proper records)

e. Outstanding and prepaid income and expense (not proper records)

14.5.2 ACCOUNTING PROCEDURE

i. Statement of Affairs Method is used to ascertain profit/loss for the accounting period.

ii. Under this method the following two statements have to be prepared:

   a. Statement of Affairs

   b. Statement of Profit and Loss

Preparing Statement of Affairs

To ascertain profit, according to incomplete records method, it is necessary to prepare a statement of affairs at the end of the year and also at the beginning of the year, if not already prepared.

Like the balance sheet, the statement of affairs has two sides – the right hand side for assets and the left-hand side for liabilities. To prepare the statement, information has to b e collected from various sources. Information about assets will be available from the cash book, the personal ledger, etc. the value of the closing stock will be ascertained by preparing stock sheets and valuing the stock on hand, at lower of cost and market value. If the trader has any other assets also, like furniture, machinery, etc., the value will be ascertained and included among the assets. The business is likely to have full knowledge of the amounts owning to third parties. The difference between the total of assets and liabilities will be capital.

Capital = Total Assets – Total Liabilities

For ascertaining profit the capital in the beginning of the year must also be ascertained, if necessary, by preparing a statement of affairs as in the beginning of the year.

If the capital at the end of the year exceeds that in the beginning, it can be considered that there has been a profit.

If, on the other hand, the capital in the beginning was more than that at the end, there must have been a loss. However, two adjustments must be kept in mind for ascertaining profit.

The following formula can be used to find out profit or loss:

Profit/ (loss) = (Capital at the end + drawings – additional capital introduced) – (Capital in the beginning)

Format of statement of affairs

Statement of Affairs as at —

Liabilities	Amounts (Rs.)	Assets	Amounts (Rs.)
Bills Payable	****	Land and Building	****
Creditors	****	Machinery	****
Outstanding expenses	****	Furniture	****
Capital (balancing figure)*	****	Stock	****
		Debtors	****
		Cash and Bank	****
		Prepaid expenses	****
		Capital (balancing figure)*	****

Note: * where the total of liabilities side is more than total of assets side, capital would be shown in assets side and it represents debit balance of capital

Preparing Statement of Profit and Loss

Once the amount of capital, both at the beginning and at the end is computed with the help of statement of affairs, a statement of profit and loss is prepared to ascertain the exact amount of profit or loss made during the year. The difference between the opening and closing capital represents its increase or decrease which is to be adjusted for withdrawals made by the owner or any fresh capital introduced by him during the accounting period inorder to arrive at the amount of profit or loss made during the period.

The statement of profit and loss is prepared as shown in figure below.

Format of statement of Profit and Loss

Statement of Profit or Loss

for the year ended ....

Particulars	Amounts
Capital at the end	****
Add: Drawings made during the year	****
Less: Additional Capital introduced during the year	****
Less: Capital in the beginning	****
Profit or loss for the year	****

Note: - Drawings means amount used or withdrawn by the owner for his personal use.

Example 1

Mr. Rakesh maintains books on single entry system; He gives you the following information.

Cap. on Jan 1. 2012	6, 80,000
Cap. on Jan 1 2013	7, 20,000
Drawings during 2012	1, 00,000
Additional Capital introduced during 2012	80,000

You are required to calculate profit or loss made by Rakesh during the year 2012.

Solution

Statement of Profit or loss

For the year ended 31st Dec 2012.

Particulars	**Amount (Rs.)**
Capital as on 1.1.2013	7,20,000
Add : Drawings during 2012	(+) 1,00,000
Less : Additional capital introduced during 2012	(-)80,000
Less : Capital as on 1.1.2012	(-) 6,80,000
Profit made during 2012	**60,000**

14.6 INCOMPLETE RECORDS AND PARTNERSHIP FIRMS

The accounting treatment for a partnership firm under this system is mostly similar to those adopted in sole proprietorship business that we have discussed so far in this chapter. But the accounting treatment differs in the following aspects:

- Items of appropriations (interest on capital, interest on drawings, partners' commission, salary and so on) are to be shown separately after calculating the profits before such appropriations. This is adopted in order to distribute the final profits among the partners in their profit sharing ratio only.

- Adjustments relating to items of appropriations: they have to be added to or deducted from the profits calculated.

- While preparing the Statement of Affairs in the beginning and at the end of the accounting period, only combined capital figures have to be recorded.

14.7 SUMMARY

- Incomplete Double Entry System (single entry) is 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.

- Salient features: (i) limited companies cannot follow; (ii) personal accounts alone are kept; (iii) business as well as private transactions are mixed up; (iv) no uniformity in maintenance; (v) profit or loss assessment is an estimate only; (vi) no subsidiary books but only vouchers and (vii) lacks accuracy.

14.8 KEY WORDS

- *Incomplete Records:* Accounting records that are not being maintained strictly on the basis of Double Entry System. This is also known as Single Entry System.

- *Conversion Method:* A method to convert books of accounts maintained on single entry into Double Entry System.

- *Statement of Affairs:* A statement enlisting items of assets and liabilities in order to determine the capital in the beginning and at the end of an accounting period.

- *Statement of Affairs Method:* The method to determine profit/loss from incomplete records. This is also known as net worth method or capital comparison.

14.9 SELF-ASSESSMENT QUESTIONS

- What are incomplete records?

- What are the possible reasons for maintaining incomplete records?

- Differentiate between a Statement of Affairs and a Balance Sheet?

- Distinguish between single entry system and double entry system.

14.10 FURTHER READINGS

- Jain and Narang, “Financial Accounting” Kalyani Publishers New Delhi.
- T.S. Grewal, “Double Entry Book Keeping” Sultan Chand and Sons, 23 Darya

  Ganj, N. Delhi.
- Gupta R.L. “Advanced Financial Accounting,” M. Radhaswamy and Sultan Chand & Sons, New Delhi (2002).
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- Kieso D.E. and J.J. Weygardt, “Intermediate Accounting,” John Wiley, New York, 1969.
- Maheswari S.N. and S.K. Maheswari, “Financial Accounting,” Vikas publishing House, New Delhi, 2006.

UNIT–15 ACCOUNTS FROM INCOMPLETE RECORDS

Objectives :

After studying the chapter, you will be able to:

- Detect the missing figures/information by preparing the relevant account. distinguish between Balance Sheet and Statement of Affairs;
- calculate Profit or Loss using the Statement of Affairs Method;
- prepare Profit and Loss Account and the Balance Sheet;

Structure :

15.1 INTRODUCTION

An account from incomplete records is the system in which we convert single entry system into double entry system. As per accounting rules, single entry system can only show incomplete records because accountant (who follows this single entry system) do not records the expenses and revenue. He just record total cash and credit. It means, it is very difficult to know the profit or loss of such business because we cannot make profit and loss account in single entry system. For converting incomplete records into complete records with double entry system, we need current year's profit or loss.

15.2 CONVERSION METHOD

As we had seen earlier, single entry system records only personal accounts. Real and nominal accounts are not given recognition, but when the need arises. We have to collect, compute and record the missing information with the help of some information available from the incompletes records. This can be done by the following the so called scientific double entry system. By preparing the statement of affairs at the beginning and end of a particular year, we can find out the opening capital and closing capital. The information that is not available like Credit sales, Bills receivable received from debtors, Credit Purchases and any other information in relation there to can be easily found out with the help of the preparation of Debtors account, Bills receivable account, Creditors account and Bills payable account. Thus with the figures available in the incomplete records, the missing figures like sales, purchases, gross profit, operating expenses, cash stolen, Net profit can be found out. The process of collecting information with the available data from the incomplete records is known as conversion method.

15.3 ABRIDGED CONVERSION METHOD

There is a way to obtain final results by short cut method. When a summary of cash and other transactions are given; information regarding assets and liabilities in the beginning and at the end of the year is available, the final accounts can be drawn. In such a case, the missing items which may be any of the following are to be found out from the given data:-

1. Capital
2. Credit purchase
3. Credit sales
4. Other Items (see next chapter)

Any of these items when unknown may be found out preparing a total debtors account and a total creditors account.

Total Debtors Account

To Opening balance **(1)** To Credit sales **(2)** To B/R dishonoured - if any **(3)**		By Cash received from debtors **(4)** By B/R Received **(5)** By Returns inwards **(6)** By Discount allowed **(7)** By Bad debts **(8)** By Closing Balance **(9)**	

Total Creditors Account

By Cash paid to creditors **(4)** By B/P granted**(5)** By Returns outwards **(6)** By Discount received **(7)** By Closing Balance **(8)**		To Opening balance **(1)** To Credit purchases **(2)** To B/P dishonoured - if any **(3)**	

15.3.1 CAPITAL

If capital is unknown prepare the statement of affairs. The difference of assets and liabilities will represent the capital.

15.3.2 CREDIT PURCHASES

If credit purchases are unknown it can be ascertained from the total creditors account. Add item No. 4, 5, 6, 7, 8 and subtract from the result item No. 1 and 3. It can also be calculated in the following way:

Acceptance given to creditors	xxxxx
Cash paid to creditors	xxxxx
Discount allowed by customers	xxxxx
Returns outwards	xxxxx
Creditors at the close of the year	xxxxx
Less creditors at the beginning	xxxxx
Credit purchases for the year	**xxxxx**

15.3.3 CREDIT SALES

If credit sales are unknown, it can be ascertain from the total debtors account. Add No. 4, 5, 6, 7, 8, 9 and subtract from the result item No. 1 and 3. It can be calculated in the following form:

Acceptance received from debtors	xxxxx
Cash received from debtors	xxxxx
Discount allowed to debtors	xxxxx
Returns inwards	xxxxx
Debtors at the close of the year	xxxxx
Less debtors at the beginning	xxxxx
Credit sales for the year	**xxxxx**

Ascertainment of Missing Information about Credit Sales and Receivables

The present times sales are made against bills receivables by raising bills of exchange on the customers. Only when accepted by the customers, the bills of exchange become bills receivable. It is to be noted that credit sales, Debtors and bills receivable are interrelated. Debtors and Bills Receivable account are therefore, prepared simultaneously.

The formats of Accounts Receivables (total debtors and Bills Receivable) are as follows:

Total Debtors Account

Dr. Cr.

Particulars	**Amount ₹**	**Particulars**	**Amount ₹**
Opening balance	****	Cash (received)	****
Bills Receivable (Dishhonoured)	****	Bank (Cheques received)	****
Bank (Cheques Dishhonoured)	****	Discount allowed	****
		Bad debts	****
		Sales returns	****
		Bills Receivable (bills received)	****
		Closing Balance	****
	****		****

Bills Receivable Account

Dr. **Cr.**

Particulars	**Amount ₹**	**Particulars**	**Amount ₹**
Opening Balance	****	Cash (bills dishonoured)	****
Debtors (Bills received)	****	Bank and Discount (bills discounted)	****
		Debtors (Bills Retained & dishonoured)	****
		Accounts Payable (endorsed to creditors)	****
		Closing Balance	
	****		****

The linking items between the accounts receivable and bills receivable are: Bills receivable by customers during the period and bills receivable dishonoured during the period. By making use of connecting items missing information can be ascertained. For

Example, to calculate missing information about net sales, at first stage, bills receivable account is to be completed.

After completing the bills receivable accounts with all the items, one can attempt to complete the accounts receivable account. Once all the items in both the account are available the credit sales during the period is ascertained. This must be added to the cash sales figure available from the cash book summary to obtain total sales for the period. In case any information is available regarding sales returns, it is deducted from the total sales to obtain net sales. The figure of net sales is placed on the credit side of Profit and Loss Account.

Ascertainment of Missing Information about Credit Purchases and Payables

Credit purchases and Accounts Payables (creditors and bill payables) are interconnected. Therefore, missing information about the credit purchases and any item relating to creditors and bills payables can be obtained by preparing these accounts simultaneously. Typical Accounts Payable and Bills Payable accounts are given below.

When available information is placed in these two accounts, one can ascertain which items are missing. The connecting items between Bills Payable and Accounts Payable accounts are: bill accepted during the year against credit purchases, and dishonoured bills payable. By making use of connecting items, missing information can be ascertained. For example, to calculate missing information about purchases, the bills payable account is to be completed/ closed.

Once the bills payable account is completed with all the required items then accounts payable account needs tobe completed. The total credit purchases made during the year will be available on the credit side of accounts payable account. By adding cash purchases (available from the cashbook summary) to this figure we obtain total purchases made during the period. If there are purchase returns, they have to be deducted from the total purchases to get the net purchases. This figure of net purchases can be placed on the debit side of the Profit and Loss Account.

Total Creditors Account

Dr. Cr.

Particulars	**Amount ₹**	**Particulars**	**Amount ₹**
Cash (Paid)	****	Opening balance	****
Bank (Cheques issued)	****	Bank	****
Bills Receivable (Endorsed)	****	**Bills payable** (Bills dishhonoured)	****
Bills Payable (Bills accepted)	****	Credit Purchases	****
Discount received	****		
Purchases returns	****		
Closing Balance	****		
	****		****

Bills Payable Account

Dr. **Cr.**

Particulars	**Amount** ₹	**Particulars**	**Amount** ₹
Bank (bills matured)	****	Opening Balance	****
Creditors	****	**Creditors**	****
Bills dishonoured	****	(Bills accepted)	
Closing Balance	****		
	****		****

Illustration 1 (Computation of credit purchases)

The following information is available to you from the books of M/s Gya n Traders. Prepare accounts payable account to find out the missing information, if any.

Cash paid to accounts payable	Rs.7,500
Cheques paid through bank	Rs.5,000
Bills endorsed	Rs.7,250
Bills accepted during the year	Rs17,500
Discount received	Rs.2,500
Purchases returns	Rs.1,250
Opening balance of accounts	Rs.7,500
(Payable as on 1 April 2002)	
Cheques dishonoured	Rs.4,000
Bills dishonoured (bills payable)	Rs.5,000
Balance of accounts payable	Rs12,500

M/s GyanTraders

Dr. Accounts Payable Account as on 31 March Cr.

Date	Particulars	J.F.	Amounts ₹	Date	Particulars	J.F.	Amounts ₹
	Cash (Paid)		7,500		Balance b/f		7,500
	Bank (cheques dishonored)		5,000		Bank (cheques issued)		4,000
	Bills Receivable (Bill endorsed)		7,250		Bills Payable (bills dishonoured)		5,000
	Bills Payable		17,500		Purchases (Credit) (Balancing figure)		37,000
	Discount received		2,500				
	Purchases returns		1,250				
	Closing Balance		12,500				
			53,500				**53,500**

15.4 PREPARATION OF FINAL ACCOUNTS

Let us now take up few comprehensive illustrations and study how complete final accounts can be prepared from incomplete records.

Illustration 9

Rakesh Washing House did not keep his book of accounts under double entry system. From the following information available from his records, prepare Profit and Loss account for the year ending 31-3-2013 and a balance sheet as on that date, depreciating the washing equipment @ 10%

Receipts	**Amount (₹)**	**Payments**	**Amount (₹)**
Balance b/f		Cash Purchases	7,000
(Opening Balance)	4,000	Paid to Creditors	10,000
Cash Sales	20,000	Sundry Expenses	3,000
Received from accounts		Cartage	1,000
Receivable	15,000		
	39,000		**39,000**

Other Information

	31.03.2013 (₹)	**31.03.2013 (₹)**
Accounts Receivable	4500	6000
Accounts Payable	7200	3400
Stock of Materials	5000	8000
Washing Equipment	20000	20000
Furniture	1500	1500
Discount allowed during the year		700
Discount Received during the year		850

Solution

Accounts Receivable Account

Dr. Cr.

Date	**Particulars**	**J.F.**	**Amount (₹)**	**Date**	**Particulars**	**J.F.**	**Amount (₹)**
	Balance b/f (Opning)		4,500		Cash		15,000
	Credit Sales		17,200		Discount Allowed		700
	(Balancing Figure)				Balance c/f		6,000
			21,700		(Closing)		21,700

Accounts Payable Account

Dr. Cr.

Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
	Cash		10,000		Balance b/f		7,200
	Discount		850		(Opening)		
	Received		3,400		Credit Purchase		7,050
	(Balance c/f (Closing)				(Balancing Figure)		
			14,250				14,250

Statement of Affairs as on 1.4.2012

Particulars	Amount (₹)	Particulars	Amount (₹)
Accounts Payable	7,200	Washing Equipment	20,000
Owner's Equity	27,800	Furniture	1,500
(Balancing Figure)		Stock of Material	5,000
		Accounts Receivable	4,500
		Cash	4,000
	35,000		35,000

Profit and Loss Account

for the year ending 31.03.2012

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
Opening Stock		5,000	Sales		
Purchases:			Cash	20,000	
Cash	14,000		Credit	17,200	37,200
Credit	7,050	14,050	Closing Stock		8,000
Cartage		1,000			
Gross Profit c/f		25,150			
		45,200			45,200
Sundry Expenses		3,000	Gross Profit b/f		25,150
Discount Allowed		700	Discount Received		850
Depreciation on					
Washing equipment		2,000			
Net Profit transferred to					
Capital a/c		20,300			
		26,000			26,000

Balance Sheet as on 31.3.2013

Liabilities		Amount (₹)	Assets		Amount (₹)
Owner Equity	27,800		Washing Equipment	20,000	
Add: Net Profit	20,300		Less: Depreciation	2,000	18,000
	48,100		Furniture		1,500
Less: Drawings	4,000	44,100	Stock of materials		8,000
Accounts Payable		3,400	Accounts Receivable		6,000
			Cash		14,000
		47,500			**47,500**

15.5 MEMORANDUM TRADING ACCOUNT

When it is not possible to ascertain the exact value of stock (destroyed by fire) from the stock register, the value of stock on the date of fire can be ascertained by constructing a Memorandum Trading Account for a period starting from the first day of the accounting period and ending on the date of fire . The following is a format of Memorandum Trading Account.

Memorandum Trading Account

For the period from 1st day of the accounting year to the date of fire

Dr. **Cr.**

Particulars	Amounts ₹	Particulars	Amounts ₹
To Opening Stock	****	By Sales	****
To purchase A/c	****	Less: Return Inwards	
Less: Return Outwards		By Closing Stock	****
To Direct Expenses A/c	****	(Balancing Figure)	

To Carriage Inwards A/c To Wages A/c To Gross Profit (% on Sales)	**** **** ****		
	****		****

The different items of the above Memorandum Trading Account are gathered as follows:

Debit Side

- **Opening Stock:** It is nothing but the closing stock of the last accounting period. Therefore it can be ascertained from the Balance Sheet of the last accounting period.
- **Purchases:** These can be ascertained from the purchase Day Book (credit purchases) and Cash Book(cash purchases)
- **Return Outwards:** It can be ascertained from the Return Outwards Book.
- **Direct expenses:** These can be ascertained from the Cash Book.
- **Carriage Inwards:** It can be ascertained from the Cash Book.
- **Wages:** These can be ascertained from the Wages Register and Cash Book.
- **Gross Profit:** It is calculated on sales, based on usual gross profit percentage of the last few years. In the examination, sometimes readymade gross profit percentage may not be available. In that case, it is to be calculated on the basis of given information. Generally, information is related to last accounting year. At the time of calculation of gross profit percentage on sales, all the necessary adjustments must be made for:
  - The slow moving items;
  - Goods distributed as free sample;
  - Goods taken by the proprietor/partners for personal use; and
  - Over-valuation or under-valuation of stock.

Credit Side

- **Sales:** These can be ascertained from the Sales Day Book(credit sales) and Cash Book (cash sales).

- **Return Inwards:** It can be ascertained from the Return Inwards Book.

The difference between the debit side total and credit side total of the Memorandum Trading Account represents the estimated closing stock on the date of fire.

15.6 SUMMARY

- Incomplete record (single entry) is a system of book-keeping in which as a rule only record of cash and personal accounts are maintained; it is always incomplete record varying with circumstances.

- **Preparation of Final Accounts** When cash summary of a firm is available along with information about personal accounts of creditors and customers, an attempt can be made to prepare the Profit and Loss Account and Balance Sheet. Missing figures about purchases, sales, debtors, and creditors can be obtained by preparing format accounts of debtors, creditors, bills receivables and bills payable using the logic of double entry system. Once a Profit and Loss Account and Balance Sheet are prepared, it will be possible for the firm to start a complete accounting system for future.

15.7 KEY WORDS

Capital: Cash or goods used to generate income either by investing in a business or a different income property.
Credit Sales: Purchases made by a consumer that do not require a payment made in full at the time of purchase.

Credit Purchase: Credit purchase is a purchase No need to Pay at the time of Purchase but liable to be paid in future. The person to whom we are liable is called creditor.

15.8 SELF-ASSESSMENT QUESTIONS

1. How can Credit Sales be ascertained from incomplete records?

2. How can Credit purchases be ascertained from incomplete records?

15.9 FURTHER READINGS

- Gupta R.L. "Advanced Financial Accounting," M. Radhaswamy and Sultan Chand & Sons, New Delhi (2002).

- T.S. Grewal, "Double Entry Book Keeping" Sultan Chand and Sons, 23 Darya

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UNIT-16 ACCOUNTS FROM INCOMPLETE RECORDS

Objectives :

After studying the chapter, you will be able to:

- Ascertainment of missing item like B/R, received bills payable accepted, cash sales and cash purchases.
- How to prepare final Accounts

Structure :

16.1 INTRODUCTION

Sometimes, businesses, especially small businesses do not maintain a full set of double entry records. Consequently, no trial balance will be produced and a complete set of final accounts cannot be prepared without further analysis of the records that do exist. Where only records available are the assets and liabilities at the beginning of the year and at the end of the year, it is not possible to prepare a Trading and Profit and Loss account. The assets and liabilities are usually listed in a **Statement of Affairs** (Similar to a Balance Sheet). This would have been called a Balance Sheet if it had been drawn up from a set of double entry records. Like a Balance Sheet, a Statement of Affairs can be prepared horizontally or vertically. The only way the profit for the year can be found is by comparing the capital shown in the opening Statement of Affairs with the capital shown in the closing Statement of Affairs.

16.2 ASCERTAINED THE MISSING INFORMATION

Under the first method only the amount of profit or loss may be ascertained and no other useful information can be derived like what is cost of production of goods sold, what is the amount of sales, closing stock, debtors, creditors etc, so for having detailed information conversion method is followed which is just like final accounts which you will study in the later on. The only difference between conversion method of single entry system and final accounts of double entry system is that unlike double entry system under single entry system no trial balance is prepared therefore complete information required for preparing final accounts is not available in case of single entry system. Thus to find out the missing information some accounts are prepared in a fixed order and then final accounts are prepared in the usual way.

Meaning

To ascertain gross profit and net profit of a business entity, it becomes essential to convert single entry records to double entry records.

Accounting procedure involved in the conversion of single entry into double entry is termed as Conversion Method or Final Accounts Method.

Conversion Method Features

This involves lengthy and time-consuming process of journalising, posting balancing and preparing the trial balance. In practice, such a logical sequence of preparation of accounts is not feasible.

In practice, final accounts may be prepared from the available records and need not be relied entirely on Trial Balance. So figures relating to certain items may be prepared directly. If it cannot be done, such missing figures can be ascertained by preparing the respective ledger accounts.

Process to ascertain the missing figures.

The following tabular column will help to ascertain the missing figures.

Missing Figure	Name of the Account to be Prepared	Method of Computing in the Missing Figure
Cash sales	Cash/bank account summary	Balancing figure – and cash sales = Total sales – Net credit sales
Cash purchases	Cash/bank account summary	Balancing figure – and cash purchases = Total purchases – Net credit purchases
Cash and bank balance (opening and closing)	Cash/bank account summary	Format of cash book is drawn, i.e. cash and bank account summary. All the figures (given in the question) are transferred to this account. Balancing figure – desired result

16.3 ABRIDGED CONVERSION METHOD

There is a way to obtain final results by short cut method. When a summary of cash and other transactions are given; information regarding assets and liabilities in the beginning and at the end of the year is available, the final accounts can be drawn. In such a case, the missing items which may be any of the following are to be found out from the given data:-

1. Bills receivable
2. Bills payable
3. Sundry debtors
4. Cash in hand and at bank
5. Stock in the beginning

Any of these items when unknown may be found out preparing a total debtors account and a total creditors account.

Total Debtors Account

To Opening balance **(1)** To Credit sales **(2)** To B/R dishonoured if any **(3)**		By Cash received from debtors **(4)** By B/R Received **(5)** By Returns inwards **(6)** By Discount allowed **(7)** By Bad debts **(8)** By Closing Balance **(9)**	

Total Creditors Account

By Cash paid to creditors **(4)** By B/P granted**(5)** By Returns outwards **(6)** By Discount received **(7)** By Closing Balance **(8)**		To Opening balance **(1)** To Credit purchases **(2)** To B/P dishonoured - if any **(3)**	

16.3.1 BILLS RECEIVABLE

I bill receivable are unknown the same may be ascertained from the total debtors account. The formula is:

Item Nos. [(1) + (2) + (3)] - [(4) + (6) + (7) + (8) + (9)]

It may also be ascertained in the following form:

Bills receivable in hand on 1-1-2012	xxxxx
Acceptance received during the year	xxxxx
Less bills dishonoured	xxxxx
Less bills honored	xxxxx
Bills receivable on 31st December	xxxxx

16.3.2 BILLS PAYABLE

If bills payable are unknown the same may be ascertained from total creditors account:

Item Nos. [(1) + (2) + (3)] - [(4) + (6) + (7) + (8)]

It may also be calculated in the following form

Bills payable in hand on 1-1-2012	xxxxx
Acceptance given during the year	xxxxx
Less acceptance honored	xxxxx
Bills payable on 31st December	xxxxx

16.3.3 SUNDRY DEBTORS

If opening balance of sundry debtors are unknown we can calculate it by the following method:

Item Nos. [(4) + (5) + (6) + (7) + (8) + (9)] - [(3) + (2)]

If closing balance of debtors is unknown:

Item Nos. [(1) + (2) + (3)] - [(4) + (5) + (6) + (7) + (8)]

16.3.4 SUNDRY CREDITORS

If opening balance of sundry Creditors are unknown we can calculate it by the following method:

Item Nos. [(4) + (5) + (6) + (7) + (8)] - [(2) + (3)]

If closing balance of Creditors is unknown:

Item Nos. [(1) + (2) + (3)] - [(4)+ (5) + (6) + (7)]

16.3.5 OPENING STOCK

Sometime opening stock is unknown, if it is unknown it can be calculated from sales. In such a case from sales fin out the cost price of the goods sold. Add in the cost of goods sold the closing stock. Subtract from the result purchases during the year.

Example:

A trader started business on 1st January, 2012 with a capital of Rs.50,000. He kept only a cash book and a personal ledger. An analysis of the cash book for the year 2012 gave the following figures:

Receipt from debtors Rs.1,40,000; cash sales Rs.42,000; payment to creditors Rs.1,00,000; expenses paid Rs.22,000; personal drawings Rs.10,000; cash purchases Rs.36,000.

On 31st December, 2012 the stock in hand was valued at Rs.20,000 and the debtors and creditors were Rs.1,20,000 and Rs. 1,10,000 respectively.

You are required to prepare a profit and loss account for the year ended 31st December, 2012 and a balance sheet as on that date, after making a reserve of Rs.2,000 fro bad and doubtful debts.

Solution:

Calculation of credit purchases:	**₹**
Cash paid to creditors	1,00,000
Add creditors on 31-12-2012	1,10,000
Credit purchases	2,10,000

Total purchases = Credit purchases + Cash purchases
Total purchases = 2,10,000 + 36,000 = 2,46,000

Calculation of Credit Sales:	**₹**
Cash received from debtors	1,40,000
Add debtors on 31-12-2012	1,20,000
Credit purchases	2,60,000

Total sales = Credit sales + Cash sales
Total purchases = 2,60,000 + 42,000 = 3,02,000

Trading and Profit and Loss Account
For the year ended 31st December, 2019

To Purchases To Gross profit c/d	2,46,000 76,000	By sales By stock 31-12-2012	3,02,000 20,000
	3,22,000		3,22,000
To Expenses To Reserve for bad debts To Net profit	22,000 2,000 52,000	By Gross profit b/d	76,000
	76,000		76,000

Balance Sheet as on 31st December, 2019

Liabilities		₹	Assets		₹
Sundry creditors Capital: Less drawings	 50,000 52,000 ------- 1,02,000 10,000 -------	1,10,000 92,000 -------- 2,02,000 ======	Cash in hand Sundry debtors Less reserve Stock	 1,20,000 2,000 ------	64,000 1,18,000 20,000 -------- 2,02,000 ======

Note: For cash in hand and at the end of the year prepare cash book [Receipts: 50,000+1,40,000+42,000] - [Payments: 1,00,000 + 22,000 + 10,000 + 36,000] and find out the balance.

16.4 STATEMENT OF CASH TRANSACTION TO ASCERTAIN MISSING INFORMATION

Summary of cash transactions record the cash receipts and cash payments. Cash receipts indicates opening balance of cash and receipts on account of cash sales, cash received from debtors, cash collected on maturity of bills receivable and other receipts such as interest, commission and tax refund. The cash payment includes payment to creditors, payment on retirements of bills payables, payments of dues, expenses and taxes. The withdrawals made by the proprietor/partner are also shown on the payments side along with the closing balance. While preparing cash book summary one may find a missing figure. In case of bank transactions, a bank overdraft appears on the other side. The balancing figure has to be carefully identified as the missing figure.

To ascertain missing information for preparation of final accounts, all the information available should be carefully recorded by simultaneously opening relevant accounts. Then, balance those accounts, which have only one missing information pass transfer entries by making use of connecting items.

Finding the missing Information

Particulars	**Source of Information**
Closing Assets (except stock) and Liabilities, Capital.	Closing Statement of Affairs
Opening Assets, Liabilities and Capital	Opening Statement of Affairs
Purchases (Cash and Credit)	Accounts Payable, Purchases Account, Cash Summary Statement
Sales (Cash and Credit)	Cash Sales from Cash Summary, Credit Sales from Accounts Receivable Account and Sales Account
Expenses and Revenues	As per Cash Summary Statement and additional information for outstanding and prepaid expenses
Losses and Gains	From all the accounts and scattered information
Bills Receivable received	Bills receivable Account/Account Receivable Account
Bills Payable accepted	Bills Payable Account/Accounts Payable Account
Opening and Closing balance of Cash	Summary of Cash and bank transactions.

Calculation of Missing Figures with the Help of Necessary Ledger Accounts

(a) Finding out credit sales, or opening debtors or closing debtors or cash received from debtors or any other information related to the above can be easily found out by preparing a Total Debtors account as given below:

Format of a Total Debtors A/c

Dr. Cr.

Particulars	Amounts (₹)	Particulars	Amounts (₹)
To Balance b/d (opening balance)	xxx	By Cash received (either given or balancing figure)	xxx
To Bills receivable (dishonoured)	xxx	By Bank	xxx
To Freight (charged)	xxx	By Bills receivable	xxx
To Interest on overdue A/c	xxx	By Discounts	xxx
To Cash (refund for return)	xxx	By Return inwards	xxx
To Credit sales of given (if not given, balancing Figure is credit sales)	xxx	By Bad debts	xxx
		By Transfer to Creditors	xxx
		By Balance c/d (closing Balance) either given or Balancing figure)	xxx
	xxx		xxx

(b) Finding out Bills receivable at the beginning or at the end of the academic year. A Bills receivable account is to be prepared to find out opening Bills receivable or closing Bills receivable or cash received on the bill or any other information as given below:

Format of a Bills Receivable A/c

Dr. **Cr.**

Particulars	Amounts (₹)	Particulars	Amounts (₹)
To Balance b/d opening Balance)	xxx	By Cash	xxx
To Sundry debtors (B/R Received during the year)	xxx	By Sundry debors (B/R Dishonoured)	xxx
		By Balance c/d	xxx
	xxx		xxx

(c) Finding out Bills payable opening or at the end of the academic year or cash paid on Bills payable:

By preparing Bills payable account any of the items given in the format below cash be ascertained:

Format of a Bills Payable A/c

Dr. **Cr.**

Particulars	Amounts (₹)	Particulars	Amounts (₹)
To Cash	xxx	By Balance b/d	xxx
To Sundry Creditors (B/P dishonoured)	xxx	By Sundry Creditors	xxx
	xxx		xxx

(d) Opening Creditors, or Creditors at the end of the academic year or Credit Purchase can be ascertained by preparing a Total Creditors a/c

Format of a Total Creditors A/c

Dr. Cr.

Particulars	Amounts (Rs.)	Particulars	Amounts (Rs.)
To Cash paid (either given Or balancing figure)	xxx	By Balance b/d (opening balance)	xxx
To Bank	xxx	By Cash (refund for returns etc)	xxx
To Bills payable	xxx	By Bills payable dishonoured	xxx
To Returns outwards	xxx		
To Discount received	xxx	By Credit purchases (either given or balancing figure)	xxx
To Allowance & rebates			
To Transfer from debtors	xxx		
To Balance c/d (closing balance)	xxx		
	xxx		xxx

(e) Opening balance of cash or closing balance of cash or cash stolen from the till can be detected by preparing a cash account or Bank account as the case may be.

16.5 SUMMARY

- Before beginning to build up and analyse the summary cash and bank accounts, it is important to obtain the client's assurance that he has made available all the requisite information pertaining to his business, and that no business receipts or expenses have been passed through other bank, deposit or petty cash accounts. Failing this, it is desirable to examine such other bank statements.

- The adequacy of the final accounts depends largely on the care with which summary cash and bank accounts are prepared. Normally at least some records are available (bank statements, some vouchers, possibly a cash book) but by definition they will be incomplete because either (a) items have been recorded but are unexplained and unsupported, or (b) items have been wholly omitted.
- **Preparation of Profit and Loss Account and Balance Sheet:** When cash summary of a firm is available along with information about personal accounts of creditors and customers, an attempt can be made to prepare the Profit and Loss Account and Balance Sheet. Missing figures about purchases, sales, debtors, and creditors can be obtained by preparing performa accounts of debtors, creditors, bills receivables and bills payable using the logic of double entry system. Once a Profit and Loss Account and Balance Sheet are prepared, it will be possible for the firm to start a complete accounting system for future.

16.6 KEY POINT

- Before solving the question, find out the missing items. The next step should be to find out the missing items from the given items in the question. After making sure that, all the items necessary for the for the preparation of the required account, then start preparation. The final accounts will be prepared as in the case of a sole trader's final account. The depreciation on fixed assets is calculated by comparing the opening and closing values of the concerned fixed asset.

16.7 SELF-ASSESSMENT QUESTIONS

1. How can payments to creditors be ascertained from incomplete records?
2. How can Bill Receivable drawn be ascertained from incomplete records?

16.8 FURTHER READINGS

- Gupta R.L. "Advanced Financial Accounting," M. Radhaswamy and Sultan Chand & Sons, New Delhi (2002).
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Bachelor of BusinessAdministration

BBA-106

Financial Accounting

॥ सरस्वती नः सुभगा मयस्करत् ॥

Uttar Pradesh Rajarshi Tandon
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BLOCK

5

ACCOUNTS OF NON-TRADING CONCERNS, DEPRECIATION PROVISIONS AND RESERVES

UNIT-17

Accounts of Non-Trading Concerns-I

UNIT-18

Accounts of Non-Trading Concerns-II

UNIT-19

Depreciation

UNIT-20

Provisions and Reserve

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UNIT-17 ACCOUNTS OF NON- TRADING CONCERNS

Objective :

After studying this unit you should able to

- Accounting of Non- Trading Concerns
- final accounts-receipts and payments account
- income and expenditure account
- balance sheet, some peculiar items

Structure :

17.1 INTRODUCTION

Concerns such as clubs, associations, hospitals, educational institutions, trade unions, charitable institutions are not established with the object of earning profit but to serve for their members. Hence, they would not prepare the normal trading and profit and loss account. But to avoid misappropriation and embezzlement of members' funds, it is necessary to prepare or keep proper books of accounts.

17.2 MEANING OF NON-TRADING CONCERN

Non- Trading Concern refers to the Concern that is for used for the welfare of the society and are set up as charitable institutions which function without any profit motive. Their main aim is to provide service to a specific group or the public at large. Normally, they do not manufacture, purchase or sell goods and may not have credit transactions. Hence they need not maintain many books of account (as the trading concerns do) and Trading and Profit and Loss Account. The funds raised by such Concern are credited to capital fund or general fund. The major sources of their income usually are subscriptions from their member's donations, grants-in-aid, income from investments, etc. The main objective of keeping records in such Concern is to meet the statutory requirement and help them in exercising control over utilisation of their funds. They also have to prepare the financial statements at the end of each accounting period (usually a financial year) and ascertain their income and expenditure and the financial position, and submit them to the statutory authority called Registrar of Societies.

17.3 CHARACTERISTICS OF SUCH CONCERN ARE

- Such Concern are formed for providing service to a specific group or public at large such as education, health care, recreation, sports and so on without any consideration of caste, creed and colour. Its sole aim is to provide service either free of cost or at nominal cost, and not to earn profit.

- These are organised as charitable trusts/societies and subscribers to such organisation are called members.

- The Non- Trading Concern earns their reputation on the basis of their contributions to the welfare of the society rather than on the customers' or owners' satisfaction.

- Their affairs are usually managed by a managing/executive committee elected by its members.

- The accounting information provided by such Concern is meant for the present and potential contributors meet the statutory requirement.

- The main sources of income of such Concern are: (i) subscriptions from members, (ii) donations, (iii) legacies, (iv) grant-in-aid, (v) income from investments, etc.

- The funds raised by such Concern through various sources are credited to capital fund or general fund.

- The surplus generated in the form of excess of income over expenditure is not distributed amongst the members. It is simply added in the capital fund.

17.4 ACCOUNTING RECORDS OF NON- TRADING CONCERN

As stated earlier, normally such Concern are not engaged in any trading or business activities. The main sources of their income are subscriptions from members, donations, financial assistance from government and income from investments. Most of their transactions are in cash or through the bank. These institutions are required by law to keep proper accounting records and keep proper control over the utilization of their funds. This is why they usually keep a cash book in which all receipts and payments are duly recorded. They also maintain a ledger containing the accounts of all incomes, expenses, assets and liabilities which facilitates the preparation of financial statements at the end of the accounting period. In addition, they are required to maintain a stock register to keep complete record of all fixed assets and the consumables.

They do not maintain any capital account. Instead they maintain capital fund which is also called general fund that goes on accumulating due to surpluses generated, life membership fee, donation, legacies, etc. received from year to year. In fact, a proper system of accounting is desirable to avoid or minimise the chances of misappropriations or embezzlement of the funds contributed by the members and other donors.

Final Accounts or Financial Statements: The Non- Trading Concern are also required to prepare financial statements at the end of the each accounting period. Although these Concern are non profit making entities and they are not required to make Trading and Profit & Loss Account but it is necessary to know whether the income during the year was sufficient to meet the expenses or not. Not only that they have to provide the necessary financial information to members, donors, and contributors and also to the Registrar of Societies. For this purpose, they have to prepare their final accounts at the end of the accounting period and the general principles of accounting are fully applicable in their preparation on as stated earlier, the final accounts of a 'Non- Trading Concern' consist of the following:

- **Receipt and Payment Account**

- **Income and Expenditure Account, and**

- **Balance Sheet.**

17.4.1 RECEIPT AND PAYMENT ACCOUNT

It is prepared at the end of the accounting year on the basis of cash receipts and cash payments recorded in the cash book. It simply is a summary of cash and bank transactions under various heads. For example, subscriptions received from the members on different dates which appear on the debit side of the cash book, shall be shown on the receipts side of the Receipt and Payment Account as one item with its total amount. Similarly, salary, rent, electricity charges paid from time to time as recorded on the credit side of the cash book but the total salary paid, total rent paid, total electricity charges paid during the year appear on the payment side of the Receipt and Payment Account. Thus, Receipt and Payment Account gives summarised picture of various receipts and payments, irrespective of whether they pertain to the current period, previous period or succeeding period or whether they are of capital or revenue nature. It may be noted that this account does not show any -non item like depreciation. The opening balance in Receipt and Payment Account represents cash in hand/ cash at bank which is shown on its receipts side and the closing balance of this account represents cash in hand and bank balance as at the end of the year, which appear on the credit side of the Receipt and Payment Account. However, if it is bank overdraft at the end it shall be shown on its debit side as the last item. Let us look at the cash book given in example how the total amount of each item of receipt and payment has been worked out.

Preparation of Receipt and Payment Account

- Take the opening balances of cash in hand and cash at bank and enter them on the debit side. In case there is bank overdraft at the begining of the year, enter the same on the credit side of this account.
- Show the total amounts of all receipts on its debit side irrespective of their nature (whether capital or revenue) and whether they pertain to past, current and future periods.
- Show the total amounts of all payments on its credit side irrespective of their nature (whether capital or revenue) and whether they pertain to past, current and future periods.
- None of the receivable income and payable expense is to be entered in this account as they do not involve inflow or outflow of cash.
- Find out the difference between the total of debit side and the total of credit side of the account and enter the same on the credit side as the closing balance of cash/bank. In case, however, the total of the credit side is more than that of the total of the debit side, show the difference on the debit as bank overdraft and close the account.

Format of Receipt and Payment Account

Receipt and Payment Account

for the year ending ————-

Receipts	Amount ₹	Payments	Amount ₹
Balance b/d Cash in HandCash at Bank Subscriptions General Donations Sale of newspaper/ periodicals/waste paper Sale of old sports materials Interest on fixed deposits Interest/Dividend on general investments Locker Rent Sale of scraps Proceeds from charity show Miscellaneous receipts Grant-in-aid** Legacies Specific Donations Sale of Investments Sale of Fixed Assets Life ` membership fees Entrance fees Receipts on account of specific purpose funds Interest on specific funds' investments Balance b/d (Bank overdraft)*	xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx	Balance b/d (Bank overdraft) Wages and Salaries Rent Rates and Taxes Insurance Printing and Stationery Postage and courier Advertise ment Sundry expenses Telephone charges Entertain ment expenses Audit fees Honorarium Repair and Renewa ls Upkeep of ground Convey ance Newspapers and Periodicals Purchases of Assets Purchase of Investments Balance c/d Cash in hand Cash at Bank*	xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx

*There will be either of the two amounts i.e., each at bank or bank overdraft, not both.

It may be noted that the receipts side of the Receipt and Payment Account gives a list of revenue receipts (for past, current and future periods)as well as capital receipts. Similarly, the payments side of the Receipts and Payments Account lists the Revenue Payments (for past, current and future periods) as well as Capital Payments.

17.4.2 INCOME AND EXPENDITURE ACCOUNT

Income and expenditure account is merely another name for profit and loss account. Such type of profit and loss account is generally adopted by non trading concerns like clubs, societies, hospitals, and like etc. This account is credited with all earnings (both realized and unrealized) and debited with all expenses (both paid and unpaid) The difference represents a surplus of deficiency for a given period which is carried to the capital account. It should be noted that items of receipts or payments of capital nature such as legacies, purchases or sales of any fixed assets must not be included in this account.

Preparation of Income and Expenditure Account

Following steps may be helpful in preparing an Income and Expenditure Account from a given Receipt and Payment Account:

- Pursue the Receipt and Payment Account thoroughly.
- Exclude the opening and closing balances of cash and bank as they are not an income.
- Exclude the capital receipts and capital payments as these are to be shown in the Balance Sheet.
- Consider only the revenue receipts to be shown on the income side of Income and Expenditure Account. Some of these need to be adjusted by excluding the amounts relating to the preceding and the succeeding periods and including the amounts relating to the current year not yet received.
- Take the revenue expenses to the expenditure side of the Income and Expenditure Account with due adjustments as per the additional information provided relating to the amounts received in advance and these not yet received.
- Consider the following items not appearing in the Receipt and Payment Account that need to be taken into account for determining the surplus/ deficit for the current year :

  (a) Depreciation of fixed assets.

  (b) Provision for doubtful debts, if required.

(c) Profit or loss on sale of fixed assets.

1. Format of Income and Expenditure account:

Income & Expenditure Account

For the year ending on . . . .

Dr. **Cr.**

Expenditure		Amount (₹)	Income		Amount (₹)
To Salaries and wages paid	xxxx		By Subscription Received	xxxx	
Add:Outstanding at the end	xxxx		Add Outstanding at the end	xxxx	
Less: Prepaid at the end	xxxx		Less: advance in the end	xxxx	
Add: Prepaid at the beginning	xxxx		Add: Advance in the beginning	xxxx	
Less: outstanding at the beginning	xxxx	xxxx	Less: O/s in the beginning	xxxx	xxxx
To Rent, Rates and Taxes		xxxx	By Entrance fees(only that portion which is to be treated as revenue)		xxxx
To Insurance Premium		xxxx	By General Donation		xxxx
To Depreciation on Furniture and sports equipments		xxxx	By Life membership fees (only that portion which is to be treated as revenue)		xxxx
To Books & Periodicals		xxxx	By Profit from Annual Dinner Contribution	xxxx	
To Audit fees		xxxx	Less Expenses	xxxx	xxxx

To Printing and stationary	xxxx	By Profit on Annual sports (Receipts-expenses)	xxxx
To Honorarium	xxxx	By Profit on Sale of Provisions	xxxx
To Bank Charges	xxxx	(Sale+closing Stock – Purchase-Opening Stock)	
To Postage and Telephone	xxxx	By Rent of Club Hall	xxxx
To Electricity and water	xxxx	By Dividend and Interest	xxxx
To Conveyance and Travelling	xxxx	By Sundry Receipts	xxxx
To Sundry Expenses	xxxx	By deficit i.e. Excess of	
To Surplus I,e excess of.	xxxx	Expenditure over Income	xxxx
Income over Expenditure	xxxx		
	xxxx		xxxx

17.4.3 BALANCE SHEET

Non- Trading Organisations prepare Balance Sheet for ascertaining the financial position of the organisation. The preparation of their Balance Sheet is on the same pattern as that of the business entities. It shows assets and liabilities as at the end of the year. Assets are shown on the right hand side and the liabilities on the left hand side. However, there will be a Capital Fund or General Fund in place of the Capital and the surplus on deficit as per Income and Expenditure Account shall be added to/deducted to this fund. It is also a common practice to add some of the capitalised items like legacies, entrance fees and life membership fees directly in the capital fund. Besides the Capital or General Fund, there may be other funds created for specific purposes or to meet the requirements of the contributors/donors such as building fund, sports fund, etc. Such funds are shown separately in the liabilities side of the balance sheet.

Sometimes it becomes necessary to prepare Balance Sheet as at the beginning of the year in order to find out the opening balance of the capital/general fund.

Preparation of Balance Sheet

The following procedure is adopted to prepare the Balance Sheet:

1. Take the Capital/General Fund as per the opening balance sheet and add surplus from the Income and Expenditure Account. Further, add entrance fees, legacies, life membership fees, etc. received during the year.
2. Take all the fixed assets (not sold/discarded/or destroyed during the year) with additions (from the Receipts and Payments account) after charging depreciation (as per Income and Expenditure account) and show them on the assets side.
3. Compare items on the receipts side of the Receipts and Payments Account with income side of the Income and Expenditure Account. This is to ascertain the amounts of: (a) subscriptions due but not yet received: (b) incomes received in advance; (c) sale of fixed assets made during the year; (d) items to be capitalised (i.e. taken directly to the Balance Sheet) e.g. legacies, interest on specific fund investment and so on.
4. Similarly compare, items on the payments side of the Receipt and Payment Account with expenditure side of the Income and Expenditure Account. This is to ascertain the amounts if: (a) outstanding expenses; (b) prepaid expenses; (c) purchase of a fixed asset during the year; (d) depreciation on fixed assets; (e) stock of consumable items like stationery in hand; (f) Closing balance of cash in hand and cash at bank as, and so on.

Format of Balance Sheet

Balance Sheet of as on ....

Liabilities	**Amount (₹)**	**Assets**	**Amount (₹)**
Capital Fund:		Assets:	
Opening Balance	****	Previous Balance	****
Add: Surplus			
OR		Add: Purchases in the current period	
Less: Deficit			
Add: Capitalized Income of the		Less: Book Value of the Asset sold/disposed off	

Current Year on account of :	****	**Closing Balance**	
Legacies	****	Stock of Consumable Items:	****
Entrance Fees	****		
Life Membership Fees	****	Previous Balance	
Closing Balance	****	Add: Purchases in the current period	
Special Fund/Donations:		Less: Value consumed during the period	
Previous Balance (If any)			
Add: Receipts for the item		**Closing Balance**	
During the period		Cash in hand and/or Cash	****
Add: Income earned on		at Bank	
Fund/Donations		Outstanding Incomes	****
Net Balance	****	Prepaid Expenses	****
Creditors for Purchases			****
And/or supplies	****		
Bank Overdraft	****		
Outstanding Expenses :			
Income received in Advance	****		
	****		****

17.5 SOME PECULIAR ITEMS

Generally in exercises the instructions are given as to the treatment of special items. Such instructions are based on the rules of the concern. These should be followed while solving questions. In cases where no specific instructions are given the following guidelines may be considered.

Legacy :

It is the amount received by the concern as per the will of the donor. It appears in the receipt side of receipt and payment account. It should not be considered as as an income but should be treated as capital receipt i.e., credited to capital fund account.

Donation :

Amount received from any source by way of gift is described as donation. It appears on the receipts side of receipt and payment account. Donations are usually credited to income. Rules of the association may provide that a part of donations are to be treated as capital. However, if donations are received for a specific purpose viz., building, free dispensary etc., then it should require special treatment. Donations for specific purposes should not be credited to income and expenditure account. Similarly donations representing heavy amount may also be treated as capital receipts.

Subscription :

The members of the associations, as per rules, are generally required to make annual subscription to enable it to serve the purpose for which it was created. It appears on the receipts side of the receipt and payment account and is usually credited to income. Care must be exercised to take credit for only those subscriptions which are relevant.

Life Membership Fees :

Generally the members are required to make the payment in a lump sum only once which enables them the members for whole of life. Life members are not required to pay the annual membership fees. As life membership fees is substitute for annual membership fees therefore, it is desirable that life membership fees should be credited to separate fund and fair portion be credited to income in subsequent years. In the examination question if there is no instruction as to what portion be treated as income then whole of it should be treated as capital.

Entrance Fees :

Entrance fees are also an item to be found on the receipt side of receipts and payments account. There are arguments that it should be treated as capital receipt because entrance fees is to be paid by every member only once (i.e., when enrolled as member) hence it is non-recurring in nature. But another argument is that since members to be enrolled every year and receipt of entrance fees is a regular item, therefore, it should be credited to income. In the absence of the instructions any one of the above treatment may be followed but students should append a note justifying their treatment.

Sale of News Papers, Periodicals etc.

As the old newspapers, magazines, and periodicals etc. are to be disposed of every year, the receipts on account of such sales should be treated as income, and therefore to be credited to income and expenditure account.

Sales of Sports Material :

Sale of support materials (used) is also a regular feature of the clubs. Sales proceeds should be treated as income, and therefore to be credited to income and expenditure account.

Honorarium :

Persons may be invited to deliver lectures or artists may be invited to give their performance by a club (for its members). Any money so paid is termed as honorarium and not salary. Such honorarium represents expenditure and will be debited to income and expenditure account.

Special Fund :

Legacies and donations may be received for specified purchases. As discussed above these should be credited to special fund and all expenses related to such fund are shown by way of deduction from the respective fund and not as expenditure in income and expenditure account.

Capital Fund :

Any concern - whether profit seeking or non profit seeking - requires money for conducting day to day functions. In the case of profit seeking concerns such money is called "capital", while in the case of non profit seeking concerns it is called "capital fund". The excess of total assets over total external liabilities of a concern is called capital fund. Capital fund is created with surplus revenue and capital receipts and incomes. It is shown on liabilities side of balance sheet.

Accumulated fund :

A non-profit oriented organization has an accumulated fund n lace of capital. It is in effect the same as capital i.e. accumulated fund =assets – liabilities

17.6 SUMMARY

- Difference between Profit making organisation - and Non Profit organization. Profit- making organization undertake activities such as manufacturing trading, banking and insurance to bring financial gain to the owners. Non-Profit entities exist to provide services to the member or to the society at large. Such entities might sometimes carry on trading activities but the profits arising there from are used for further the service objectives.

- Receipt and payment account is a mere summary of cash book for a year. It begins with the cash in hand at the commencement and ends with that at the close of the year. Similarly to cash account, in receipts and payments account receipts are shown on the debit side while payments are shown on the credit side, without any distinction between capital and revenue. Moreover, it does not include an unpaid expenditure not any unrealized income relating to the period under review and so fails to reveal the financial position on the concern.

17.7 KEY WORDS

- Not for Profit Organisations are sports clubs, charitable institutions, schools, welfare societies, health clubs, blood banks, etc.Their objective is to serve its members and public in general.

- Summary of Cash Book entries for the year when presented in the form of an Account is called Receipts and Payments A/c.

- All cash transactions are recorded in Receipts and Payments Account irrespective of the transaction being of capital nature or revenue and whether belong to current year or preceding or succeeding year.
- Receipts and Payments Account is the Cash Book in summary form and becomes the basis of preparing Income and Expenditure A/c and balance Sheet of a Not for Profit organisation.
- Specific items of receipts are subscription, entrance fees, Life membership fees, Endowment fund, Donations, Legacy, sale of old newspapers, government grant, etc. Specific items of payments are purchase of fixed assets, consumable stores, honorarium, etc.

17.8 SELF- ASSESSMENT QUESTION

- State the meaning of 'Non- Trading' Organisations.
- State the meaning of Receipt and Payment Account.
- What is an Income and Expenditure Account?
- What are the feature of Receipt and Payment Account?

17.9 FURTHER READINGS

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UNIT–18 ACCOUNTS OF NON- TRADING CONCERNS

Objective :

After studying this unit you should able to

- Preparation of income and expenditure account and balance sheet,
- Preparation of receipts & payments account from income and expenditure account,
- Preparation of balance sheet from receipts & payments and income and expenditure accounts,
- How to prepare final accounts of professionals.

Structure :

18.1 INTRODUCTION

One may ask, if profit-making is not the main motive of these organisations then what is the necessity of preparing final accounts. In order to ascertain the members, the donors and the society, it is necessary to prepare final accounts, in particular, about their activities. Misuse or non-utilisation of income can be detected only by keeping proper accounting procedure. Proper accounting facilitates the task of further growth of such entities. So it has become a necessity to prepare such accounts. More or less the same accounting system is adopted as in the case of profit-making entities.

18.2 PREPARATION OF AN INCOME AND EXPENDITURE ACCOUNT FROM A RECEIPTS AND PAYMENTS ACCOUNT

The cash Book entries have been summarized into the Receipts and Payment Account, information necessary to prepare Income and Expenditure Account will be largely found in it. A scrutiny of the receipts side will show what items are of revenue nature and also relate to the present period. These will appear on the credit side of the Income and Expenditure Account. The practical steps involved in the preparation of an Income and Expenditure Account from the Receipts and payments Account are as follows:

1. Ascertain the Revenue Income (e.g., subscriptions) for the current accounting Period as under and show on the credit side of Income and Expenditure Account:

		`
Revenue Receipts as per cash Book during the current year		xxxx
Add: Outstanding Income at the end of current year	xxxx	
Advance Income in the beginning of current year	xxxx	xxxx
		xxxx
Less: Outstanding income at the beginning of current year	xxxx	
Advance income at the end of current year	xxxx	
Revenue Income for the current year		**xxxx**

2. Ascertain Revenue Expenses for the current accounting Period as under and show on the debit side of Income & Expenditure Account:

		₹
Revenue Payments as per cash Book during the current year		xxxx
Add: Outstanding expenses at the end of current year	xxxx	
Prepaid expenses in the beginning of current year	xxxx	xxxx
		xxxx
Less: Outstanding expenses in the beginning of current year	xxxx	
Prepaid expenses at the end of current year	xxxx	
Revenue Expenses for the current year		**xxxx**

3. Ascertain the non-cash expenses from the additional information and show charges on the debit side of Income and Expenditure Account.

4. Calculate the amount of profit or loss on trading activities and show the amount of profit on the credit side of Income and expenditure Account or the amount of loss on the debit side of Income and Expenditure Account separately.

5. Coleculate the difference between the total of dabit side and the total of Credit side. If the total of debit side exceeds the total of credit side show the Deficit (i.e. excess of Expenditure over Income) on the credit side. If the total of credit side exceeds the total debit side, show the surplus (i.e. excess of Income over Expenditure) on debit side of Income and Expenditure Account.

6. Balance sheet is prepared after Income and Expenditure Account unless contrary information is given.

Illustration-1

From the following Receipts and Payments Account of a club and from the information given prepare Income and Expenditure Account for the year ending 31st December 2011 and the Balance sheet as on that date

Receipts and Payments Account

For the year ending 31st Dec. 2012

Dr. Cr.

Receipts		Amount (₹)	Payments	Amount (₹)
To Balance b/d		1050	By Salaries	4200
To Subscriptions :			By General Expenses	900
2011	750		By Electric Charges	600
2012	3000		By Books	1,500
2013	600	4,350	By Newspapers	1,200
To Rent Received from the use of the Hall		2,100	By Balance c/d	600
To Profit from Entertainment		1,200		
To Sale of Newspapers		300		
		9,000		9,000

Additional Information

1) The club has 50 members each paying an annual subscription of ` 75, subscription outstanding on 31 Dec. 2011 was ` 900.
2) On 31st Dec. 2012 Salaries outstanding amounted to ` 300. Salaries paid in 2012 included ` 900 for the year 2011.
3) On 1.1.2012 the club owned Building valued at ` 30000, furniture ` 3000 and books ` 3000.
4) Provide depreciation on furniture at 10% P.A.

Solution

Income and Expenditure Account

For the year ending 31st Dec. 2012

Dr. Cr.

Expenditure		Amount (₹)	Income	Amount (₹)
To Salaries	4,200		By Annual Subscription	3,750
Add: Outstanding Salaries	300		of 50 members @ 75 ₹	
	4,500		By Rent of Hall	2,100
Less: Salaries Paid for 2011	900	3,600	By Profit from single Entertainment	1,200
To General Expenses		900	By Sale of Newspaper	300
To Electric Charges		600		
To Newspapers Purchases		1,200		
To Depreciation on Furniture		300		
To Surplus		750		
(Excess of Income over Expenditure)				
		7,350		**7,350**

Balance Sheet

as on 31st Dec. 2012

Dr. Cr.

Expenditure	Amount (₹)	Income		Amount (₹)
To Salaries Outstanding	300	Cash		600
Subscription Received in advance	600	Subscription Outstanding		
Capital Fund		2011	150	

Opening Balance	37050		2012	750	900
Add Surplus	750	37800	Furniture	3000	
			Less: Depreciation	300	2700
			Books	3000	
			Add Purchases	1500	4500
			Building		30000
		38700			38700

Working Note: Calculation of capital fund as on 01.01.2012

Balance Sheet

as on 1 Jan 2012

Liabilities	**Amount (₹)**	**Assets**	**Amount (₹)**
Salaries Outstanding	900	Cash	1,050
Capital Fund	37,050	Furniture	3,000
(Balancing Figure)		Books	3,000
		Buildings	30,000
		Subscription Due	900
	37,950		37,950

18.3 PREPARATION OF RECEIPTS AND PAYMENTS ACCOUNTS FROM INCOME AND EXPENDITURE ACCOUNT

From following Explanation you will easily understand the process of Preparing Receipts and Payments Account from Income and expenditure account and the necessary information.

1. Ascertain the opening cash and Bank Balance (or Bank overdraft) from the additional information or from the opening Balance Sheet (if available) and show the cash and Bank balance on the debit side and Bank overdraft on the credit side of Receipts and payments Accounts.

2. Ascertain 'Revenue Receipts' received during the current accounting period as under and show on the debit side of Receipts and Payments Accounts:

		₹
Revenue income for the current year as per Income & Expenditure A/c		xxxx
Add: Outstanding income in the beginning of current year	xxxx	
Advance Income at the end of current year	xxxx	xxxx
Less: Outstanding income at the end of current year	xxxx	
Advance income in the beginning of current year	xxxx	xxxx
Revenue Receipts during the current year		xxxx

3. Ascertain Revenue payments made during the current accounting Period as under and show on the credit side of Receipts and Payment Accounts.

		₹
Revenue Expenses for the current year as per Income & Expenditure A/c		xxxx
Add: Outstanding Expenses in the beginning of current year	xxxx	
Prepaid Expenses at the end of current year	xxxx	xxxx
		xxxx
Less: Outstanding Expenses at the end of current year	xxxx	
Prepaid Expenses in the beginning of current year	xxxx	
Revenue Payments during the current year		xxxx

4. Ascertain all capital receipts (e.g. life Membership fees/Entrance fees) and capital Payments (e.g. Purchase of Fixed Assets) From the additional information or Balance Sheet (if available) or by preparing the accounts of capital items such as fixed assets, special funds and show the capital receipts on the debit side and the capital payment on the credit side of the Receipts and Payments Accounts.

5. Calculate the difference between the total of debit side and the total of credit side. If the total of debit side exceeds the total of credit side, show the cash Balance (if the Bank Balance is given) or the Bank Balance (if the Cash Balance is given) on the credit side of the Receipts and Payments Accounts. If the total of credit side exceeds the total of debit side, show the Bank Overdraft on the debit side of Receipts and Payments Account.

6. According to circumstances and seeing the nature of question, Receipts and payments and payment Account is to be prepared.

Illustration –2

From the following Income and Expenditure Accounts Prepare the receipts and payments Accounts for the year 2012

Income and Expenditure Account

Dr. Cr.

Expenditure		Amount (₹)	Income		Amount (₹)
To lesson Sale of sport Material (Book Value ` 1000/-)		600	By Subscription Received	20000	
To Rent Paid	12000		Add: O/s at the end	8000	
Add: O/s at the end	3000		Add: Advance in the beg	6000	
Less: O/s in the beg	6000	9,000	Less: O/S in the beg	12000	
To Insurance Premium paid	12000	,	Less: Advance at the end	4000	18,000
Add: Prepaid in the beginning	3000		By Entrance fees		12,000
Less: Prepaid in the end	6000	9,000	(40% Capitalised)		

To Sports Materials	8000		By Life Membership fees		8,000
Add: Opening Stock	4000		(60% capitalised)		
Less: Closing Stock	2000	100000	By General Donation		20,000
To Newpapers and Periodicals		2,400	By loker rent		
To Depreciation @ 10% on old Building		6,000	Received	8000	
To Depreciation @ 10% on new furniture		2,000	Add: Oustanding at the end	6000	
(Purchased on 1.1.2012)			Less: Advance at the end	2000	
To Salaries		9,000	By Interest on 12%		
To Surplus		60,000	General fund Investment		
			Received	20000	
			Add: Accrued	4000	24,000
			By Sale of newspaper		200
			By Income from charity show		
			Charity Show proceeds	21800	
			Less: show Expenses	8000	13,800
		108000			**108000**

Note: Cash Balance as on 1.1..2012 and on 31.12.2012 ₹ 1000 and 64000 respectively Bank Balance a on 1.1.2012 ₹2000

Solution:

Receipt and payments Account

For year ending 31st December 2012

Dr **Cr**

Receipts	**Amount (₹)**	**Payments**	**Amount (₹)**
To Balance b/d:		By Rent	12,000
Cash	1,000	By Insurance premium	12,000
Bank	2,000	BySports Materials Purchased	8,000
To Subscription	20,000		2,400
To Entrance fees (`12000%60)	20,000	By Newspapers & Periodicals	20,000
		By Furniture(`2000%10)	9,000
To Life Members Fees (8000%40)	20,000	By Salaries	8,000
To General Donation		By Charity show Expenses	64,000
To loker Rent	20,000	By Balance C/d	
To Interest on 12% General	8,000	Cash	
	20,000		
Fund Investment			
To sale of Newspapers	200		
To Proceeds of Charity show	21,800		
	400		
To Sale of Sport Materials(`1000-`600)			
To Balance C/d	2,000		
(Bank over draft)			
(Balance Figure)			
	1,35,400		**1,35,400**

18.4 PREPARATION OF BALANCE SHEET FROM RECEIPTS & PAYMENTSACCOUNT AND INCOME & EXPENDITURE ACCOUNT

A balance sheet is the statements of Assets and Liabilities of an accounting unit at a given Particular date. Its prepaid at the end of an accounting period after the Income & Expenditure Account . These steps are as follows are involved in the preparation of a Balance sheet :

1. Open only one account for each of the various items given in Reeipts and Payments Account, Income and Expenditure Account and additional Information avoiding duplication.

2. Post the following items in various ledger accounts are as follows:

(i) Receipts shown on the debit side of Receipts and Payments Account	Show on the credit side of respective account
(ii) Payments down on the credit side of Receipts and Payments Account.	Show on the debit side of respective account
(iii) Revenue Expanses and losses shown on the Debit side of Income & Expenditure Account.	Show on the credit side of respective account
(iv) Revenue Income shown on the credit side of Income & Expenditure Account.	Show on the debit side of respective account.

3. Calculate the difference between the total of debit side and the total of credit side of each account. Show the difference as of opening Balance closing Balance as the case may be.

4. Prepare opening Balance Sheet on the basis of Opening Balance (Including Opening cash and Bank Balance) and closing Balance sheet on the basis of closing Balances (Including closing cash and Bank Balances).

Note: Expenses paid for current year and Income received for current year will not appear in the Balance sheet.

Illustration-3

Prepare Balance sheet of chetna Sports club's from Income & Expenditure and Receipts & Payments Account for the year as on 31.12.2011 & 31.12.2012. The following Particulars are as

Income & Expenditure Account

For year ending 31st December 2012

Dr **Cr**

Expenditure	**Amount (₹)**	**Income**	**Amount (₹)**
To Salaries	750	By Entrance Fees	5,050
To Advertising	800	By Subscription	7,800
To Audit Fees	50	By Rent	2,000
To Printing & Stationary	1,100		
To Fire Insurance	500		
To Depreciation on Sport Equipments	4,500		
To Excess of Income over Expenditure	7,150		
	14,850		14,850

Receipts & Payment Account

For year ending 31st December 2012

Dr **Cr**

Receipts		Amount (₹)	Payments	Amount (₹)
To Balance b/d		2,100	By Salary	500
To Entrance Fees		5,050	By Printing & Stationary	1,300
To Subscriptions			By Advertising	800
2011	300		By Fire Insurance	600
2012	7,500		By Investment	10,000
2013	200	8,000	By Balance c/d	3,700
To Rent Received		1,750		
		16,900		16,900

The assets on 1 Jan 2012 included chetna Sports club ground and pavilion ` 22000, sports equipments ` 12500 and Furniture & Fixtures ` 2000. Subscription in arrears on that date was ` 400.

Balance Sheet

as on 31st December 2011

Liabilities	**Amount (₹)**	**Assets**	**Amount (₹)**
Capital Fund	39,000	Cash	2,100
(Balancing Figure)		Sports Equipments	12,500
		Club Ground and Pavilion	22,000
		Furniture & Fixtures	2,000
		Subscription in arrear	400
	39,000		39,000

Balance Sheet

as on 31st December 2011

Liabilities		Amount (₹)	Assets		Amount (₹)
Salaries Outstanding		250	Cash in hand		3,700
Audit fees Outstanding		50	Sports Equipments	12500	
Subscription received			Less: Depriciation	4500	8,000
Advanced		200	Club ground and Pavillion		22,000
Capital Fund	39000		Furniture and Fixtures		2,000

Add Surplus	7150	46150	Investments		10,000
			Prepaid Printing and Stationary		200
			Prepaid Insurance		100
			Rent Received		250
			Subscription Due :		
			2011	100	
			2012	300	400
		46650			46,650

18.5 FINAL ACCOUNTS OF PROFESSIONALS

Professional means Chartered Account, Doctors, Lawyers, Architects, Engineers, Cost Accountant, Company Secretaries, Solicitors etc. or Professionals firms generally prefer to prepare Income and Expenditure Account to find out surplus generated from professional activities during a particular accounting Period, Receipt and Expenditure Account for allocation of such surplus and Balance sheet to show financial Position at the end of a Particular period. They may keep their accounts on complete double entry system and extract a trial balance and then proceed. Usually, however they keep note on cash transactions only, preparing a Receipt and Expenditure Account. Income and Expenditure Account is then Prepared on its basis. There is one point to be remembered in this case. Professional people prepare their accounts considering income on cash basis, that is, they ignore outstanding income. The practical guidelines for preparing final Accounts of a professional firm are given below:

STEPS FOR PREPARING FINAL ACCOUNTS OF PROFESSIONALS

Professionals prepare Receipts and Disbursement Accounts, Income and Expenditure Account, Capital Accounts and Balance sheet etc. cash book is also prepared following is worth consideration in this respect

(1) All expenses paid and outstanding are recorded

(2) Fees might have been received or agreed but not required.

(3) The amount of fees really received is recorded

(4) Provision is made for the fees which have been accrued but not received.

(5) There may be such cases in which fees have been received in advance but whole work has not been done so far, but work is in progress. In such cases also necessary record is made.

(6) Clients ledger is also maintained in order to keep clients' accounts. If professionals are partners, their capital accounts are opened.

(7) In order to calculate income of the concerned year, Income and Expenditure Account is prepared.

(8) Fees receivable are shown in the assets side and also in the liability side of Balance sheet, but in the liability side such amount appears in the heading of 'Provision against outstanding fees' or 'provision against fees receivable.

The formats of Income and Expenditure Account and Receipt and Expenditure Account of a professionals are as follows:

Income & Expenditure Account

for the year ending on . . . .

Dr. **Cr.**

Expenditure		**Amount (₹)**	**Income**		**Amount (₹)**
To Incomplete work			By Bills of Cost Rendered		
(in the beginning)			(fees Bill)		
A's Clients	xxxx		A's clients	xxxx	
B's Clients	xxxx	xxxx	B's Clients	xxxx	xxxx
To Salaries and wages		xxxx	By Incomplete work		
To stipend to trainees		xxxx	(at the end):		
To Printing and Stationary		xxxx	A's clients	xxxx	

To Conveyance Charges	xxxx	B's clients	xxxx	xxxx
To Travelling Expenses	xxxx			
To Postage, Telephone Exp.	xxxx			
To Depreciation	xxxx			
To Surplus transferred to Receipts & Expenditure A/c	xxxx			
	xxxx			xxxx

Receipts and Expenditure Account

for the year ending on . . . .

Dr. **Cr.**

Expenditure		**Amount (₹)**	**Receipts**	
To Provision for Outstanding Fees and value of Incomplete (at the end)			By Surplus Transferred From Income & Expenditure A/c	
			By provision for Outstanding fees and value of Incomplete work (in the beginning)	
A's Clients	xxxx		A's clients	xxxx
B's Clients	xxxx	xxxx	B's clients	xxxx
To Partner's Capital Account (Share indirect business)				
A	xxxx			
B	xxxx	xxxx		
To Depreciation				
A	xxxx			
B	xxxx	xxxx		
		xxxx		

Illustration-4

Dr. Bansal commenced practice as an neurologist, investing 2,500000 in equipment on 1 April 2012. The Receipts and Payment Account for the year was as follows:

Receipt & Payment Account

Dr. **Cr.**

Liabilities	**Amount (₹)**	**Assets**	**Amount (₹)**
To Fees	8,00,000	By Rent	1,80,000
To Miscellaneous Receipts	1,000	By Salaries to Assistants	2,25,000
	20,000	By Journals	10,000
		By Library Book	30,000
		By Equipment Purchased	40,000
		By Drawing	1,20,000
		By Balance	
		At Bank	215,000
		In hand	1,000
	8,21,000		**8,21,000**

`15000 of the fees was still outstanding Equipment was sold as well as purchased On Ist January 2013 the cost of the equipment sold being ` 30,000 Depreciation on equipment is 20% and on library Book & Salaries to assistants still payable is relating is` 10,000 prepare the receipts and Expenditure Account and Balance sheet relating to 2012-13.

Solution:

Receipts and Expenditure Account

For the year ending 31 March 2013

Dr. Cr.

Expenditure		Amount (₹)	Receipts		Amount (₹)
To Rent		1,80,000	By Fees: Received	8,00,000	
To salaries to Assessments :			Add: Fees	15,000	815000
Paid	2,25,000		By Miscellaneous Receipts		1000
Add: O/s salaries	10,000				
To Journals		10,000			
To Depreciation on:					
Equipments	50500				
Library Books	1500	52,000			
To Reserve for O/s Fees		15,000			
To Lesson sale of Equipments		5,500			
To Surplus i.e. excess of					
Income over Expenditure		3,18,500			
		8,16,000			**816000**

Balance Sheet

as on 31 March 2013

Liabilities		**Amount (₹)**	**Assets**		**Amount (₹)**
Expenses Outstanding		10000	Equipment: Cost	2,50,000	
Capital: Introduced	2,50,000		Add: Additions	40,000	
Add: Surplus for the year	3,18,500			2,90,000	
	5,68,500		Less: Equipment		
Less: Drawings	1,20,000	448500	Sold	30,000	
				2,60,000	
			Less: Depreciation	46,000	214000
			Library: Cost	30,000	
			Less: Depreciation	1,500	28,500
			Outstanding Fees	15000	
			Less: Reserve	15000	
				NIL	
			Cash at Bank		215000
			Cash in hand		1000
		816000			816000

Note:

(i) Depriciation on Equipment has been calculated are as follows:

	(₹)
On ` 2,20,000 for one year	44,000
On ` 30,000 for Nine Months	4,500
On ` 40,000 for Three Months	2,000
	50,500

(ii) Loss on sale of equipments

Cost		30,000
Less: Depreciation		4,500
		25,500
Less: Sales Proceeds	20,000	
		5,500

18.6 SUMMARY

Non-trading concerns usually maintain their accounts by the double entry system and periodically prepare their final accounts for the submission to their members and subscribers.The method of preparing final accounts by non trading concerns is different than trading concerns. As these concerns do not deals in any goods like trading concerns, so they cannot prepare a trading and profit and loss account. At the end of the year they make out an account called an Income and expenditure account and balance sheet. The Income and expenditure account serve the same purpose as the profit and loss account in the case of trading concerns and is made out exactly in the same manner.Usually the non profit making institutions do not maintain a full set of books but merely a cash book in which all receipts and payments are entered. At the end of the year the cash book is summarized under suitable heads and the summary thus prepared is called a Receipt and Payment Account. In order to know the result of the year's working it should be converted into Income and expenditure account.

18.7 KEY WORDS

- Income and Expenditure Account is similar to Profit and Loss Account Income and Expenditure Account is the summary of Incomes and Expenditures of a Not for Profit Organization (NPO) of a particular year.
- Income and Expenditure Account is prepared to know the net result of the financial activities of Not for Profit organisations (NPOs) which may be either surplus or Deficit.
- Important items of expenditure are revenue expenses such as salary, postage, stationery, honorarium, depreciation etc. Main items of incomes are subscription, entrance fees etc.
- All adjustments such as outstanding, prepaid etc. are incorporated before arriving at the surplus or deficit.
- Receipts and Payments Account and Income and Expenditure Account can be differentiated on the basis of nature, side, opening balance, closing balance, capital and Revenue items adjustments and transfer of closing balance.
- Every Not for Profit organization (NPO) prepares Balance Sheet at the end of the year. It also has the asset side and the liability side. Opening balance sheet is required to prepare Balance sheet for the current year.

18.8 SELF-ASSESSMENT QUESTIONS

- Describe in brief the steps taken to prepare Income and Expenditure

  Account.
- Explain the objectives of preparing Income and Expenditure Account

18.9 FURTHER READINGS

- Anthony R.N. and J.S. Reece, "Accounting Principles," Richard D. Irwin, Inc.
- Gupta, Nirmal, "Financial Accounting," Sahitya Bhawan, Agra.
- Gupta R.L. "Advanced Financial Accounting," M. Radhaswamy and Sultan Chand & Sons, New Delhi (2002).
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- Kieso D.E. and J.J. Weygardt, "Intermediate Accounting," John Wiley, New York, 1969.
- Maheswari S.N. and S.K. Maheswari, "Financial Accounting," Vikas publishing House, New Delhi, 2006.

UNIT-19 DEPRECIATION

Objective :

After studying this unit you will be able to

- Know the Meaning and Definition of Depreciation
- Need and Causes of Depreciation
- Factors Determining the Amount of Depreciation
- Methods of Calculating Depreciation,

Structure :

19.1 Meaning and Definition

19.2 Special features of Depreciation

19.3 Need of Depreciation

19.4 Causes of Depreciation

19.5 Factors Determining the Amount of Depreciation

19.6 Methods of Calculating Depreciation

  19.6.1 Fixed Installment Method

  19.6.2 Diminishing Balance Method

19.7 Summary

Capital expenditure results in acquisition of fixed assets for utilization in the process of providing goods and services to the customers. Fixed assets are utilized during operation of business for a number of successive accounting periods. Value of fixed assets decreases with passage of time and its utilization. Value of the portion of asset utilized for generating revenue must be recovered during that accounting year to ascertain real income. Portion of the cost of a fixed asset is allocated to a particular accounting year is called depreciation and is charged to Profit & Loss Account.

19.1 MEANING AND DEFINITION

A business unit that buys a fixed asset normally expects to use it for a number of years. A fixed asset is used in the business to earn profits for a long period of time. It is not bought with the intention of selling in the normal course of business. The asset is retained in the business as long as it serves its purpose adequately. When the fixed asset is no longer useful to the business, it has to be replaced. In every business concern, small or large, fixed assets are used for carrying on business operations. Some examples of such assets are buildings, Plant and Machinery, Motor Vehicles, Furniture, office equipments, etc. These assets depreciate in value as it is used or become older. The decrease in the value of a fixed asset because of use and the passage of time is called Depreciation.

Definitions—Some of the well-known definitions of depreciation are given below:-

"Depreciation is the gradual decrease in the value of an asset from any cause." --R.N. Carter

"Deprecation is the measure of the exhaustion of the effective life of an asset from any cause during a given period."

--Spicer and Peglar

"The term 'Depreciation' represents loss or diminution in the value of an asset consequent upon wear and tear, obsolescence, effluxion of time or permanent fall in market value."

--J.R. Batiboi

19.2 SPECIAL FEATURES OF DEPRECIATION

- Depreciation is fall in the value of fixed assets (except land).
- This loss relates to the book-value, and not the market value of the fixed asset.
- Depreciation refers to revenue loss and not the capital loss.
- Depreciation is not the process of valuation of asset but process of allocation of the cost of an asset to its effective span of life.
- Depreciation is a gradual and continuing process because the value of the asset will decline either by its constant use or obsolescence due to expiry of time.
- Such loss in the value of fixed asset is of permanent nature.

19.3 NEED OF DEPRECIATION

It is not legally compulsory to charge depreciation. However, every concern charges it due to the following reasons.

- **Distinction between Capital and Revenue expenditure:--**An important accounting principle is to make a distinction between capital and revenue expenditure. The buying/purchase of a fixed asset is a capital expenditure but charging depreciation on that against profit is revenue expenditure. If no depreciation is provided, the distinction between the above two cannot be made.

- **For showing the 'true and fair view' of the financial position :** In case, the fixed assets are shown in the Balance sheet, without charging depreciation on them, the balance sheet would not show the true and fair view of the affairs of the business concern. Suppose a machine was purchased for Rs. 3, 00,000 in 2019. If no depreciation is charged that would appear in the Balance sheet with the same original cost whereas, the value of the machine has gone down considerably. Unless depreciation is charged, the value of the assets will be overstated in the Balance sheet. Depreciation should be charged to show the true profit of the business.

- **For ascertaining the true Profit and loss:--**The depreciation being revenue loss, it has to be debited to the Profit and Loss Account otherwise that would not ascertain the true profit or loss. The true profit of a business can be ascertained only when all cost incurred for the purpose of earning revenues have been debited to the Profit and Loss Account. In fact, the net profit arrived at without charging depreciation would not be correct.

- **To ascertain the accurate cost of production:**--The cost of production of an article manufactured should include all items of expenses incurred in the production operations. One such expense is depreciation. If depreciation is not taken into consideration, cost of production will be understated. In effect, pricing of the product will be inappropriate.

- **For replacement of asset:**--Depreciation though debited to Profit and Loss Account is not paid in cash like other expenses. The amount of depreciation is retained in the business and is used for the replacement of fixed assets after the expiry of their estimated span of life.

- **To prevent the distribution of profits out of capital :--**If the depreciation is not charged, the profit shown by the Profit and Loss Account will be in excess of the actual profits. Such an excess profit may be wholly withdrawn by the proprietor or may be distributed among the shareholders as dividend. Hence, The amount of dividend distributed will also include the amount of depreciation which is actually a part of capital.

- **Legal Obligation :--**According to section 205of the Companies Act 1956, it is not legally compulsory but necessary to provide depreciation in case of a Joint Stock Company. A Company cannot make payment of dividends without making provisions for depreciation. Thus, it is essential to charge depreciation if the dividend is to be paid.

- **To avail deduction from Income-**Tax :--All the business concerns whether individual, firms or companies make a provision for depreciation with a view to avail the deduction from income tax. If depreciation is not debited to Profit and Loss Account, The net profit shown by it will be in excess of actual profits Hence, the company will have to pay more income tax. Thus to avail deduction under the Income Tax Act 1961, the business concern should charge depreciation even though it is not legally compulsory.

19.4 CAUSES OF DEPRECIATION

The accounting for depreciation requires a proper understanding of the causes resulting in depreciation. The following are the causes of depreciation of fixed assets.

- **By Constant Use :--**It is the physical deterioration of a fixed assets that comes from the normal use of the asset Hence, constant use of fixed assets in business operations results in their wear and tear thereby reducing their value.

- **The Passage of Time:--**The value of majority of assets decrease with passage of time even if they are not being put to use in the business. The passage of time affects the life of an asset such as lease, copyright, patent right and so on. For example, a building is taken out on lease for 20 years at a cost of Rs. 90, 00,000. At the end of the 20 year period, the possession of the property will go back to its original owner. Thereafter, it will have no value to the business unit.

- **By obsolescence :--**Due to new inventions and improved techniques the old assets become obsolete and may have to be discarded even if they can be put to use physically. Hence, it is the fall in value of fixed assets that results due to technological change or changes in demand.

- **By Depletion:--**It is a process whereby an asset, which is a natural resource, is physically consumed in the process of use. Natural resources are those assets produced by nature which man converts to his own use. There are two sub-types:

  - Extractive resources: For example, oil, gold, coal mines etc. These are non-renewable resources and are consumed in a single use. Extraction of coal from the ground results in physical consumption of the natural resource.

  - Regenerative resources: For example, farming, forestry, fishing and the like. These are renewable resources such as a forest from which wood can be consumed. These resources can again be regenerated by growth.

- **Decay:** A fixed asset loses its quality or strength by the effect of nature. Natural forces such as rain, winds, weather, storms, moisture etc. contribute to the deterioration in its value.

- **Destruction:**-A fixed asset gradually loses its service yielding capacity as it grows old whether it is used or not. Sometimes a machine may be destroyed due to fire etc. or a motor car may be damaged due to accident.

19.5 FACTORS DETERMINING THE AMOUNT OF DEPRECIATION

In the process of measuring depreciation of a fixed asset, the following factors should be considered:

- **Cost of the Asset:--**The cost of a fixed asset is determined after adding all expenses incurred for bringing the asset to working condition such as freight, transit insurance and installation costs etc. For example, freight of a plant or machinery includes the purchase price, installation costs, insurance premium and the like.

- **Estimated useful life of the asset:--**Useful life of an asset is estimated in terms of number of years, it can be effectively used for business operations. The useful life of a fixed asset is its service life. The amount of depreciation also depends upon the fact as to how the asset is being used.

- **Scrap Value of the Asset:--**It is estimated sale value of the asset at the end of its useful life. It is also known as residual value or breakup value. For example, a machine is purchased for Rs. 60,000 and Rs. 10,000 was spent on its freight and Rs. 5000 for installation. It is estimated that its serviceable life will be ten years at the end of which period it will have a scrap value of Rs. 11,000. Depreciation in this case will be Rs. 64,000 (i.e. 60,000 + 10,000 + 5,000 – 11,000).

Depreciation charged on this machine will be Rs 64000 = Rs. 6,400 (Every year)

- **Legal Provisions:--**Legal Provisions under the Companies Act, 1956 and Income Tax Act, 1961 have to be kept in mind while calculating depreciation.

- **Maintenance of asset:--**The amount of depreciation depends to a large extent upon the way the repairs and renewal of the asset are undertaken. The amount of depreciation will be less if the assets are properly maintained.

19.6 METHODS OF CALCULATING DEPRECIATION

There are several methods of calculating depreciation. It is not necessary that an enterprise users a single method of depreciation for all classes of its depreciable assets. Different methods are suitable for different assets depending upon the nature and type of the assets. These methods are as follows:-

- The Straight line or Fixed Instalment method.
- The Diminishing Balance Method.
- The Annuity Method.
- Depreciation Fund Method.

- Insurance Policy Method.
- Revaluation Method.
- Depletion Method.
- Machine Hour Rate method.
- The Sum of the year's digit method.

19.6.1 FIXED INSTALMENT METHOD

This method is also known as 'Original Cost Method' as under this method depreciation is charged at a fixed percentage on the original cost of the asset. Under this method, the amount of depreciation remains equal from year to year and as such the method is also known as 'Equal Instalment Method' or 'Straight Line method'. The amount of depreciation is calculated by deducting the scrap value from the original cost of the asset and the by dividing the remaining balance by the number of years of its estimated life. This is the annual amount of depreciation- The same amount each year. This method assumes that the depreciation charged annually will reduce the original cost of the asset to zero, or its scrap value, as the case may be, at the end of its estimated life. Under this, method, the amount of depreciation is calculated by the following formula:-

Annual Depreciation = Original Cost of the asset – Estimated scrap value
Estimated life of the Asset

For example, if the original cost of the asset is Rs. 1,75,000 and its scrap value is likely to be Rs. 2,5000 after its estimated life of 5 years, the depreciation written off will be

Estimated Annual Depreciation = Rs. $^{(175000-25000)/5}$ = Rs. 30,000 every year.

Advantages

- This method is very popular because of its simplicity and consistency.
- The charge of depreciation is same in each year and is, therefore, appropriate where equal amount of depreciation is debited to the Profit and loss Account each year. Thus each year enjoys benefit from the use of the asset.
- Under this method the net cost of the asset is completely written of within a definite period. Therefore, It can reduce the book value of the asset to its estimated scrap value.
- This method shows the information of original cost of the asset and its up to date depreciation at any time. The valuation of asset each year in the Balance sheet is reasonably fair.

Disadvantages

- The computation of depreciation becomes complicated when there are different machines having different life spans because the depreciation on each machine will have to be calculated separately.
- The major disadvantage of this method is that the annual depreciation amount of an asset remains the same, where as the maintenance cost of the asset keeps increasing as it gets older. Therefore the load on the profit and loss account is not equal even though the uti9lity of the asset remains the same year after year. Hence, every year equal amount should be charged from the Profit and Loss Account on account of depreciation, repairs and renewals.
- This method does not take into consideration the loss of interest on the amount invested in the asset. The amount wouldhave earned interest had it been invested the business.
- This method assumes writing off the value of asset to zero. This is an unrealistic assumption as even after the value of an asset is reduced to zero in the books; it continues to be used in the business in actual practice.
- The efficiency of a machine is more in the earlier years. As such more depreciation should be charged in earlier years in comparison to later years. But under this method, depreciation remains constant year after year.
- Under this method, no provision is made for replacement of the asset, when its life is over.

Suitability- This method is suitable for those assets which do not require many expenses on repairs and renewals and which have a comparatively shorter life and less cost such as furniture, patent, lease etc.

Accounting Entries for Depreciation

Following entries are passed in this method.

- Entry for purchase of Asset:

  Asset A/c Dr.

  To Cash/Bank A/c

- Entry for providing depreciation at the end of the year.

  Depreciation A/c Dr. (Annual Depreciation)

  To Asset A/c

- Entry for the account of Depreciation charged to P/L A/c:

  Profit and Loss A/c Dr.

  To Depreciation A/c

- Entry for the amount realized on sale of Asset:

  Cash/Bank A/c Dr.

To Asset A/c

- Entry in case of loss on sale of asset:

  Profit and Loss A/c Dr.

  To Asset A/c

- Entry in case of Profit on sale of Asset:

  Asset A/c Dr.

  To Profit and Loss A/c

Example: 1

On 1st January 2011, Shandilya purchased a machine by cheque for Rs. 1, 20,000. It was decided to write off the depreciation under the straight line method, estimating the life of the machine at 10 years and scrap value at Rs. 20,000. You are required to pass necessary Journal entries for 2011 & 2012 and show necessary accounts and Balance sheets of the relevant year. Assume that no provision for depreciation account is maintained and accounting year ends on 31st December every year.

Solution

Annual Depreciation = Rs 120000 – 20000 = Rs. 10,000

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In the books of Shandilya

Journal

Date	**Particulars**	**Dr.** **Rs. Amount**	**Cr.** **Rs. Amount**
2011 Jan. 1	Machinery A/c Dr.	1,20,000	
	To Bank A/c		1,20,000
Dec. 31	(Being the purchase of machinery by cheque) Depreciation A/c Dr.	10,000	
	To Machinery		10,000
2012 Jan. 1	(Being the depreciation charged to machinery) Depreciation A/c Dr.	10,000	
	To Machinery		10,000

Dec. 31	(Being the Depreciation charged to Machinery) Profit and Loss A/c Dr. To Depreciation A/c (Being the depreciation charged to Profit and Loss Account)	10,000	10,000

Machinery Account

Date	Particulars	JF	Rs.	Date	Particulars	JL	Rs.
2011 Jan. 1	To Bank A/c		1,20,000	2012 Dec.31	By Depreciation A/c		10,000
				Dec.31	By Balance c/d		1,10,000
			1,20,000				1,20,000
2012 Jan. 1	To Balance b/d		1,10,000	2012 Dec.31	By Depreciation A/c		10,000
				Dec.31	By Balance c/d		1,10,000
			1,10,000				1,10,000

Dr. Depreciation Account Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
2011 Dec. 31	To Machinery A/c		10,000	2011 Dec. 31	By Profit & loss a/c		10,000
2012 Dec. 31	To Machinery A/c		10,000	2012 Dec. 31	By Profit & Loss a/c		10,000

Balance Sheet as on 31st December, 2011

Liabilities	Rs.	Assets	Rs.
		Machinery	1,10,000
Balance Sheet as on 31st December, 2012			
Liabilities	Rs.	Assets	Rs.
		Machinery	1,00,000

Example: 2

On 1st January 2008 Ateeksh Limited purchased a machine for Rs. 52,000 and spent Rs. 3,000 on its carriage and Rs. 1, 00,000 on its erection. On the date of purchase, it was estimated that the effective life of the machine will be 10 years and after that its scrap value will be Rs. 6,000. Prepare Machine A/c and Depreciation A/c for four years after providing depreciation on Fixed Installment Method. Accounts are closed on 31st December each year.

Solution

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

$$= \frac{\text{Rs. } 56000 - \text{Rs. } 6000}{10} = \text{Rs. } 5{,}000$$

Machine Account

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
2008 Jan. 1	To Bank A/c	52,000	2008 Dec. 31	By Depreciation A/c	5,000
Jan. 1	To Bank A/c (Exp.)	3,000	Dec. 31	By Balance c/d	51,000
Jan. 1	To Bank A/c (Exp.)	1,000			
		56,000			56,000
2009 Jan. 1	To Balance c/d	51,000	2009 Dec. 31	By Depreciation A/c	5,000
			Dec. 31	By Balance c/d	46,000

		51,000			51,000
2010 Jan. 1	To Balance b/d	46,000	2010 Dec. 31	By Depreciation A/c	5,000
			Dec. 31	By Balance c/d	41,000
		46,000			46,000
2011 Jan. 1	To Balance	41,000	2011 Dec. 31	Depreciation A/c	5,000
			Dec. 31	By Balance c/d	36,000
		41,000			41,000
2012 Jan. 1	To Balance c/d	36,000			

Depreciation Account

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
2008 Dec.31	To Machine A/c	5,000	2008 Dec.31	By Profit & Loss A/c	5,000
2009 Dec.31	To Machine A/c	5,000	2009 Dec.31	By Profit & Loss A/c	5,000
2010 Dec.31	To Machine A/c	5,000	2010 Dec.31	By Profit & Loss A/c	5,000
2011 Dec.31	To Machine A/c	5,000	2011 Dec.31	By Profit & Loss A/c	5,000

19.6.2 DIMINISHING BALANCE METHOD

Under this method, as the value of asset goes on diminishing year after year, the amount of depreciation charged every year also goes on declining. For example, if a machine is purchased for Rs. 10,000 and depreciation is to be charged at 10% p.a., then according to 'Diminishing Balance Method', the depreciation will be charged as under:-

	Rs.
1st year on Rs. 10,000 @ 10%	1,000
2nd year on Rs. 9,000 (i.e. 10,000-1000) @ 10%	900
3rd year on Rs. 8100 (i.e. 9000-900) @ 10%	810
4th year on Rs. 7290 (i.e. 8100-810) @ 10%	729

and so on. Under this method, depreciation is calculated on the book value of the asset at the beginning of that year, rather than on the original cost. As the value of the asset and also the depreciation charged on it goes on reducing year after year this method is also known as 'Written Down Value Method.'

Advantages

- As the decreasing charge for depreciation cancels out the increasing charges for repairs over the years, it gives a fair charge for depreciation.
- No recalculation is necessary if a new asset is purchased during the life span of an asset.
- This method is applicable for income tax purposes.
- The impact of obsolescence can be reduced if a significant part of the cost is written off in early life.

Disadvantages

- This method lacks simplicity as it is difficult to the ascertain the percentage to be applied.
- This method cannot be applied for assets with a very short life.
- The asset is never fully depreciated.
- Under this method, the original cost of various assets is not shown in the Balance sheet. Sometimes, the assets are grouped in such a way that it becomes difficult to known their specific identity. The residual balance of some assets may continue in the Balance sheet even after they have been actually scrapped.
- This method does not take into consideration the loss of interest on the amount invested in the asset.

Suitability :

This method is suitable for assets having a comparatively long life and which require considerable repairs in the later years when they become older, such as building, plant etc.

Distinction between Fixed Installment Method and Diminishing Balance Method

Basic of Difference	**Fixed Installment Method**	**Diminishing Balance Method**
1. Amount of Depreciation	Equal depreciation is charged every year	Depreciation goes on decreasing year after year
2. Level	The book value of the asset can be reduced to zero	The book value of the asset can never be reduced to zero
3. Basis of Charge	Fixed Installment	Diminishing Balance
4. Basis of calculation of Depreciation	Depreciation is charged on the original cost of the asset	Depreciation is charged on the reducing balance of the asset
5. Rate of Depreciation	Rate of Depreciation is kept low in comparison to diminishing balance method	Rate of Depreciation is kept high in comparison to original cost method
6. Approval of Income tax Authorities	This method is not approved by Income tax authorities	This method is approved by Income tax authorities

Example: 3

On 1st January, 2009, Tuhina Ltd. purchased a plant and machinery for Rs. 10,000. Prepare Plant and Machinery Account for three years providing depreciation on Diminishing Balance Method @ 10% per annum.

Solution:

Plant and Machinery Account

Date	Particulars	Amount	Date	Particulars	Amount
2009			2009		
Jan. 1	To Cash A/c	10,000	Dec.31	By Depreciation (on Rs. 10,000 @ 10%)	1,000
			Dec.31	By Balance c/d	9,000
		10,000			10,000
2010			2010		
Jan. 1	To Balance b/d	9,000	Dec.31	By Depreciation (on Rs. 9,000 @ 10%)	900
			Dec.31	By Balance c/d	8,100
		9,000			9,000
2011			2011		
Jan. 1	To Balance b/d	8,100	Dec.31	By Depreciation (on Rs. 8100 @ 10%)	810
			Dec.31	By Balance c/d	7,290
		8,100			8,100
2012					
Jan. 1	To Balance b/d	7,290			

Example: 4

On 1st April, 2008, Arnav Ltd. purchased a machinery for Rs. 3,90,000 on which they spend Rs. 5,000 for carriage, Rs. 2,000 for brokerage of the middle-man, Rs. 2,500 on installation and Rs. 500 for an iron pad. On 1st Nov. 2010 they purchased another machinery for Rs. 1,00,000 and immediately spent Rs. 20,000 on its overhauling. On 30th Sept 2011, the machinery purchased in 2009 was sold at a loss for Rs. 1, 27,800. The company charged depreciation @ 10% p.a. on written down value basis. Accounts are closed on 31st March every year.

Prepare machinery Account up to 31st March, 2012.

Solution:

Date	Particulars	Amount	Date	Particulars	Amount
2008			2009		
April 1	To Bank A/c	3,90,000	Mar. 31	By Depreciation A/c	40,000
April 1	To Bank A/c (Expenses) [Rs. 5,000 + Rs. 2,000 + Rs. 2,500 + Rs. 500]	10.000	Mar. 31	By Balance c/d	3,60,000
		4,00,000			4,00,000
2010			2010		
April 1			Mar. 31	By Depreciation (i) Rs. 36,000 (ii) Rs. 5,000 (for 5 months)	
Nov. 1	To Balance A/c	3,60,000			
Nov. 1	To Balance A/c	1,00,000			41,000
	(overhauling)	20,000	2011	By Bank A/c (i)	
2011			Sep. 30	By Depreciation (i) (for six months)	
April	By Balance	4,80,000	Sep.		48,000

1	c/d (i) Rs. 3,24,000 (ii) Rs. 1,15,000	4,39,000	30 Sep. 30 2006 Mar. 31 Mar. 31	By Profit & Loss A/c By Depreciation A/c (ii) Balance c/d	1,80,000 16,200 1,27,800 11,500 1,03,500
2012 Mar. 31	To Balance b/d	4,39,000			4,39,000
		1,03,500			

Note:- (i) Calculation of sale price of machinery

Balance on April 1st, 2011	3, 24,000
Less-Depreciation for six months	16,200
	3, 07,800
	1, 27,800
Less-Loss on Sale	
Sale Price	Rs. 1, 80,000
(ii) Depreciation @ 10% on Rs. 1, 15,000	Rs. 11,500

Change in the method of Depreciation

Sometimes the method of depreciationis charged either from straight line method to diminishing balance method or from diminishing balance method to straight line method. Such a charge may be affected from prospective year or with retrospective effect.

Change in the method of Depreciation Prospectively

When the change in method is made from current year it is called prospective change in method of depreciation

Example: 5

On 1st January, 2003, Whitefield Ltd. purchased a second-hand machinery for Rs. 74,000 and spent Rs. 4,000 on its repairs and Rs. 2,000. On 1st July, 2005, the machinery purchased on 1st January, 2003 was sold for Rs. 56,000 and on the same date a fresh machinery is purchased for Rs. 50,000. On 1st July, 2005 the machinery purchased for Rs. 20,000 on 1st January, 2003 was sold for Rs. 4,000.

In 2003 depreciation was charged @ 10% p.a. on original cost of the asset. However from 2004 the company decided to write of depreciation @ 15% p.a. on written down value method.

Show Machinery Account for 4 years.

Solution:

Machinery Account

Date	Particulars	Amount	Date	Particulars	Amount
2003 Jan. 1	To Bank A/c	74,000	2003 Dec. 31	By Depreciation A/c	8,000
Jan. 1	To Bank A/c (Repairs)	4,000	Dec. 31	By Balance c/d	72,000
Jan. 1	To Bank A/c (Installation)	2,000			
		80,000			80,000
2004 Jan. 1	To Balance b/d	72,000	2004 Dec. 31	By Depreciation A/c (i) 72,000@15%10800 (ii) 20,000@15%3,000	13,800
Jan. 1	To Bank A/c	20,000	Dec. 31	By Balance c/d (i) 61,200 (ii) 17,000	78,200
		92,000			92,000
					56,000
2005 Jan. 1	To Balance c/d (i) 61,200 (ii) 17,000	78,200	2005 July 1	By Bank A/c	4,590
July 1	To Bank A/c	50,000	July 1	By Depreciation A/c (on Rs. 61,200@15% for six months)	
			July 1	By Profit & Loss A/c (Loss on Sale of Machinery [61,200 56,000-4570]	610
					6,300
			Dec.	By Depreciation A/c (i) Rs. 2,550 (ii) Rs.	60,700
		1,28,200			1,28,200

2006	To Balance b/d (i) 14,450 (ii) 46,250	60,700	31 Dec. 31	3750 (for six months) By Balance c/d (i) Rs. 14,450 (ii) Rs. 46,250	4,000 1,084 9,366 6,938 39,312
Jan. 1 2007 Jan. 1	By Balance b/d	60,700 39,312	2006 July 1 July 1 July 1 Dec. 31 Dec. 31	By Bank A/c By Depreciation A/c (15% on Rs. 14,450 for six months) By Profit & Loss A/c By Depreciation A/c By balance c/d	60,700

Change in the method Depreciation retrospectively—When the change in the method of depreciation is implemented from the date the asset was put to use it is called retrospective change. The following steps should be taken for such adjustment.

Step. 1 Calculate total Depreciation from the date of retrospective by adopting the new method of Depreciation.

Step. 2 Adjust from total depreciation under the existing method upto the date of change.

Step. 3 Pass the following entries.

(i) If total depreciation of Step 1 is greater than Step 2

Profit and Loss Adjustment Account Dr. (Difference)

To Asset Account

(ii) If the total depreciation Step 1 is less than that of Step 2

Asset Account Dr. (Difference)

To Profit and Loss Adjustment Account

Step. 4 Charge depreciation from the date of change by adopting the new method.

Example: 6

The Plant and Machinery Account of Vinay Ltd. had a debit balance of Rs. 1, 47,390 on 1st January, 2006. The Company was incorporated in 2003 and has been following the practice of charging full year's depreciation every year on diminishing balance system @ 15% In 2003. It was, however, decided to change the method from reducing system to straight line with retrospective effect from 2003 and to give effect of the change while preparing the Final Accounts for the year ended 31st December, 2006, the rate of depreciation remaining same as before.

In 2006, new machineries were purchased at a costof Rs. 50,000. All other machineries were acquired in 2003. Show the Plant and Machinery Account from 2003 to 2006.

Solution:

Plant and Machinery Account

Date	**Particulars**	**Amount Rs.**	**Date**	**Particulars**	**Amount Rs.**
2003			2003		
Jan. 1	To Bank (i)	2,40,000	Dec. 31	By Depreciation (at the rate of 15% on Rs. 2,40,000)	36,000
			Dec. 31	By Balance c/d	2,04,000
		2,40,000			2,40,000
2004			2004		
Jan. 1	To Balance b/d	2,40,000	Dec. 31	By Depreciation (at the rate of 15% on Rs. 2,04,000)	30,600
			Dec. 31	By Balance c/d	1,73,400
		2,40,000			2,40,000
2005			2005		
Jan. 1	To Balance b/d		Dec.	By Depreciation	26,010

			31	(15% of Rs. 1,73,400)	
				By Balance c/d	1,47,390
		1,73,400	Dec. 31		1,73,400
2006 Jan. 1	To Balance b/d	1,47,390	2006 Dec. 31	By Depreciation (15% of Rs. 2,40,000 + 50,000)	43,500
	To Bank purchased	50,000			
			Dec. 31	Profit & Loss A/c (2) (Extra depreciation due to change in method)	15,390
				By Balance c/d	1,38,500
		1,97,390			1,97,390
2007 Jan. 1	To Balance b/d	1,38,500	Dec. 31		

Working Notes:

- Cost of Machinery on January 1st, 2003

  $\text{Rs. } 1,47,390 \times \frac{100}{85} \times \frac{100}{85} \times \frac{100}{85} = \text{Rs. } 2,40,000$

- Depreciation to be change on Straight line method for 3 years from 2013 to 2005 :

  (15%on Rs. 2, 40,000) × 3 = Rs. 1, 08,000

Less- Depreciation already charged on diminishing balance system for 3 years from 2003 to 2005

(Rs. 36,000 + 30,000 + 26,010) = Rs. 92,610

Extra Depreciation to be charge due to change

In method Rs. 15,390

(3) Annuity Method:

This method considers the value of money and opportunity cost of capital locked up in the asset. When an amount is invested in acquiring an asset the business has to forgo some amount of interest which could have been earned if the money was instead employed in the purchase of an income producing asset, like securities.

Under this method, the total amount of depreciation written off during the life of the asset equals the net cost of the asset plus interest calculated on the reducing balance.

The rate of interest (calculated at a fixed rate percent) is applied to the cost value of the asset and the amount of interest produced added to the asset. Therefore, interest is debited to the asset (on the reducing balance) and credited to the Interest Account. Here, the asset is regarded as providing an annuity (as series of equal periodic payments occurring at equal intervals of time) and the equal amount of depreciation charged in each year is the value of the annuity.

Under this method, the annual amount of depreciation is calculated from the annuity table.

As an example, a portion of an Annuity table in given below:-

ANNUITY TABLE

Period in Years	**Rate of Interest**			
	3%	**4%**	**5%**	**6%**
1	1.030000	1.040000	1.050000	1.06000
2	0.522611	0.530196	0.537805	0.545437
3	0.353530	0.360346	0.367208	0.374110
4	0.269027	0.275490	0.282012	0.288591
5	0.218335	0.224628	0.230975	0.237396
10	0.117231	0.123291	0.129504	0.135868
15	0.083767	0.089941	0.096342	0.102963
30	0.051019	0.057830	0.065051	0.072649
50	0.38866	0.046550	0.05477	0.063444

According to the above table, the annuity of value of Rs. 1 is given at a specified rate for different years. Hence to determine the amount of depreciation, we have to find value of Re 1 from the above table and multiply it with the amount to be provided for.

Illustration:-

An asset worth Rs. 30,000 was purchased having life span of 5 years. It is decided that the depreciation be calculated by fixing an interest rate of 6% on the value of the asset through annuity. Calculate the amount of depreciation.

Since to write off an asset of Re 1 in 5 years @ 6% p.a. the depreciation = 0.237396 Therefore to write-off Rs. 30,000 in years @ 6% p.a. interest, the depreciation = 0.237396 x 30,000 = Rs. 7121.88.

This will be the value of depreciation charge annually.

Journal Entries

- For Depreciation, the entry will be as follows,

  Depreciation A/c Dr.

  To Asset A/c

  (Being depreciation on the asset)

- For interest, the entry will be

  Asset A/c Dr.

  To Interest Account

  (Being Interest on capital sunk in the asset)

- Every year, the following entry is passed to transfer interest and depreciation to Profit and Loss Account

  Interest A/c Dr.

  To Profit and Loss A/c

  (Being transfer of interest)

  Profit and Loss A/c Dr.

  To Depreciation A/c

(Being transfer of Depreciation A/c)

Example: 7

A lease was purchased on January, 2003 at a cost of Rs. 20,000 for 4 years. It was decided to charge depreciation an annuity method charging interest at the rate of 5% per annum. Prepare lease account for four years and also Profit and Loss Account Assume that the annuity value of Re 1 for 4 years at 5% is 0.282012

Solution:

As Annuity Value of Rs. 1 at 5% for 4 years is 0.0282012, the amount of Depreciation will be calculated as follows:

Depreciation = $0.0282012 \times 20,000$

= Rs. 5640.24

LEASE ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
2003			2003		
Jan. 1	To Bank A/c	20,000.00	Dec. 31	By Depreciation	5640.24
Dec. 31	To interest A/c (5% on Rs. 20,000)	1,000.00	Dec. 31	By Balance c/d	15,359.76
		21,000.00			21,000.00
2004			2004		
Jan. 1	To Balance b/d	15,359.76	Dec. 31	By Depreciation A/c	5,640.24
Jan. 1	To Interest (5% on 15359.76)	767.99	Dec. 31	By Balance c/d	10,487.51
		16,127.75			16,127.75
2005			2005		
Jan. 1	To Balance b/d	10,487.51	Dec. 31	By Depreciation A/c	5,640.24
Dec. 31	To Interest A/c	524.38	Dec. 31	By Balance c/d	5,371.65
		11,011.89			11,011.89
2006			2006		
Jan. 1	To Balance b/d	5,371.65	Dec. 31	Depreciation A/c	5,640.24
Dec. 31	To Interest A/c	268.59			

		5,640.24			5,640.24

PROFIT AND LOSS ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
2003 Jan.	To Depreciation A/c	5,640.24	2003 Dec. 31	By Interest A/c	1,000.00
2004 Dec. 31	To Depreciation A/c	5,640.24	2004 Dec. 31	By Interest A/c	769.99
2005 Dec. 31	To Depreciation A/c	5,640.24	2005 Dec. 31	By Interest A/c	524.38
2006 Dec. 31	To Depreciation A/c	5,640.24	2006 Dec. 31	By Interest A/c	268.59

Advantages:

- Under this method the economic life of an asset automatically reaches zero when the depreciation is calculated.
- This method takes into consideration the interest on capital invest alongwith the depreciation.
- This method is more scientific than other methods as it takes time value of money and opportunity cost of capital locked in the asset.

Disadvantages :

- This method does not provide any provision for replacement of asset.
- Under this method the amount of depreciation remains the same year by year whereas the amount of interest goes on decreasing. With the result, the joint burden on Profit and Loss Account does not remain equal.

- This method is not suitable for those assets in which often additions and extensions take place.

- Depreciation Fund Method—Under this method, a fixed amount is debited annually to the depreciation account and credited to the depreciation fund account. The amount in the depreciation fund account is invested in fixed paying securities. The interest earned from the investment is also invested every year. In this manner, sufficient amount remains invested in the outside securities. By the end of life of the asset, when the use of the asset is over, the investment is sold out and the money is realized. This money is easily used for the purchase of new asset in place of the old one.

The Profit and Loss, if any, after the sale of investment is transferred to the depreciation fund investment account and this account is closed.

The balance of the depreciation fund is transferred to the old asset account and the depreciation fund account is also closed. The balance of the old asset account is transferred to the Profit and Loss Account of the company and the old asset account is also closed.

Every year, the asset is shown at the original cost in the balance sheet of the company. Depreciation fund is shown in the liabilities side of the Balance sheet and the depreciation fund investment account is shown in the asset side of the Balance Sheet. The equal amount of cash to be invested each year is ascertained from the depreciation fund table.

Journal Entries

- **At the end of the first year, the following entries are passed.**
- For setting aside the required amount of depreciation

    Depreciation A/c Dr.

    To Depreciation Fund A/c

    (Being the amount of depreciation)

- For transferring depreciation to Profit and Loss Account

    Profit and Loss A/c Dr.

    To Depreciation A/c

    (Being the Transfer of depreciation)

- For investing the amount

    Depreciation Fund investment A/c Dr.

    To Bank A/c

    (Being the investment of the provision made for replacement of asset)

- **Second and subsequent years**

(i) (a) Bank A/c Dr.

To interest on Depreciation fund Investment A/c

(b) Interest on Depreciation Fund Investment A/c Dr.

To Depreciation Fund Account

(ii) For setting aside the amount

Depreciation A/c Dr.

To Depreciation Fund A/c

(iii) For transferring depreciation to Profit and Loss A/c

Profit and Loss A/c Dr.

To Depreciation A/c

- For investing (amount of depreciation plus interest)

  Depreciation Fund Investment Account Dr.

  To Bank A/c

- **Last Year**
- For interest on investment
- Bank A/c Dr.
- To Interest on Depreciation Fund Investment A/c
- Interest on Depreciation Fund Investment A/c Dr.
- To Depreciation Fund A/c
- For setting aside the Depreciation
- Depreciation A/c Dr.

  To Depreciation Fund A/c

(In the last year, the amount of depreciation and interest are not re-invested. Instead, all investments are sold)

- For sale of investment

  Bank A/c Dr.

  To Depreciation Fund Investment A/c

- For transferring Profit and Loss on sale of investment
- For Profit

  Depreciation Fund Investment A/c Dr.

  To Depreciation Fund A/c

- For Loss

Depreciation Fund A/c Dr.

To Depreciation Fund Investment A/c

- For Sale of Scrap

  Bank Account Dr.

  To Asset Account

- For Closing Depreciation Fund Account

  If there is any balance in the asset A/c it is transferred to P & L A/c

Sinking Fund Table

Sinking Fund table is used to find out the amount to be invested at a given rate for given year so that the required amount is made available at the end. The specimen of table is as follows:

Years	**3%**	**4%**	**5%**
3	0.323530	0.321934	0.316209
4	0.239027	0.237251	0.327012
5	0.188355	0.186181	0.180975
10	0.087231	0.085241	0.079505
15	0.055767	0.051825	0.046342
20	0.037216	0.035361	0.030243

Thus, if we require Rs. 50,000 after 5 years @ 5% p.a. then the amount to be invested every year will be Rs. 50,000 x 0.180975 = Rs. 9,048.75

Example: 8

On 1st July, 2003 Arushi 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 Depreciation Fund. Investment is expected to realize 5% interest. On 30th June, 2007, the machine was sold off as scrap for Rs. 18,000 and the investment were realized at 5% less than the book value. On 1st July, 2007, a new machine is installed at a cost of Rs. 1, 25,000. Sinking Fund table show that Re. 0.2320 invested each year will produce Re 1 at the end of 4 years at 5%.

Show the necessary Ledger Accounts in the books of Mohan Ltd. for all the years.

Solution:

Amount required = Rs. 1, 10,000 + 6000 – 16000 = Rs. 1, 00,000

Therefore, Annual Contribution = Rs. 1, 00,000 x 0.232

= Rs. 23,200.

MACHINERY ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
1.7.03	To Bank A/c	1,10,000	30.6.04		
	To Bank (Expenses)		Dec. 31	By Interest A/c	1,16,000
		6,000			
1.7.04			1.7.04		
				By Balance c/d	
	To Balance b/d		30.6.06	By Balance c/d	1,16,000
		1,16,000			
1.7.05	To Balance b/d		30.6.07	By Bank A/c	1,16,000
		,16,000		(Scrap Sold)	
1.7.06	To Balance b/d		“	By Depreciation Fund	1,16,000
		1,16,000	“	By P & L A/c	
					18,000
		1,16,000			96,343
					1,657
					1,16,000
		1,16,000			

DEPRECIATION FUND ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
30.6.03	To Balance c/d	23,200	30.6.03	By Depreciation A/c	23,200
30.6.04	To Balance c/d		1.7.04	By Balance b/d	23,200
		47,560	30.6.05		1,160

			"	By Interest on Investment A/c	23,200
				By Depreciation A/c	
		47,560			47,560
30.6.06	To Balance c/d	73,138	1.7.05	By Balance b/d	47,560
			30.6.06	By Interest on Investment A/c	2,378
			30.6.06	By Depreciation A/c	23,200
		73,138			73,138
30.6.07	To Depreciation Fund Investment A/c	3,657	1.7.06	By Balance b/d	73,138
	To Machinery A/c	96,343	30.6.07	By Interest on Investment A/c	3,657
			30.6.07	By Depreciation A/c	23,205
		1,00,000			1,00,000

SINKING FUND INVESTMENT ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
30.6.03	To Bank A/c	23,200	30.6.03	By Balance c/d	23,200
1.7.04	To Balance b/d	23,200	30.6.04	By Balance c/d	47,560
30.6.04	To Bank A/c (23,200+1,160)	24,360			
1.7.05	To Balance b/d	47,560	30.6.05	By Balance c/d	47,560
30.6.06	To Bank A/c (23,200+2378)				

1.7.06	To Balance b/d	47,560 25,578	30.6.07	By Bank A/c (sales) By Sinking fund A/c (Loss on sale)	73,138
		73,138			73,138
		73,138			69,481 3,657
		73,138			73,138

5. Insurance Policy Method:

This method is similar to Depreciation Fund Method but instead of investing the money in securities, the amount is used in paying premium on a policy taken out with an insurance company. The policy should mature immediately after the expiry of the useful life of the asset. The money that is received from the insurance company is used to replace the asset under this method. Though the interest received is lower that could be obtained by investing in securities, the risk of loss on realization of securities is avoided.

Journal Entries:

Following entries are passed in this regard.

- For yearly depreciation

Depreciation A/c Dr.

To Depreciation Reserve Fund A/c

(Being the depreciation of asset)

- For transferring depreciation to Profit and Loss Account

Profit and Loss A/c Dr.

To Depreciation A/c

(Being the amount of Depreciation debited to Profit and Loss A/c)

(c) For payment of yearly premium

Depreciation Insurance policy A/c Dr.

To Bank A/c

(Being the payment of premium on Depreciation policy)

Note: No entry will be passed in respect of interest which will be earned.

(d) If there is any balance in the Depreciation Insurance Policy Account, it should be transferred to Depreciation Reserve Fund Account Assuming that the realized amount of policy is greater than the total paid, the following entry will be passed.

Depreciation Insurance Policy A/c Dr.

To Depreciation Reserve fund A/c

(e) For realization on Insurance Policy

Bank A/c Dr.

To Depreciation Insurance Policy A/c

(f) For sale of asset

(i) Bank A/c Dr.

To Asset A/c

(Being the residual value realized by selling the asset)

(ii) Depreciation Reserve fund A/c Dr.

To Asset A/c

(g) if there is any balance lying in the Asset Account, it should be transferred to Profit and Loss A/c to close the Asset A/c.

Example: 9

A machine was purchased for Rs. 30,000 on 1st January, 2003. It is to be replaced after four years. For this, an insurance policy is taken for four years. An annual premium of Rs. 6.900 is to be paid for it. A new machine was purchased for Rs. 34,000 and the old machine was written off. Prepare Depreciation Reserve Fund A/c, Depreciation Insurance Policy A/c.

Solution:

DEPRECIATION RESERVE FUND ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
2003 Dec. 31	To Balance b/d	6,900	2003 Dec. 31	By Depreciation A/c	6,900
2004 Dec. 31	To Balance c/d	13,800	2004 Dec. 31 Dec. 31	By Balance b/d By Depreciation	6,900 6,900

				A/c	
2005 Dec. 31	To Balance c/d	13,800	2005 Dec. 31 Dec. 31	By Balance b/d	13,800
		20,700		By Depreciation A/c	13,800 6,900
2006 Dec. 31	To Machinery	20,700	2006 Dec. 31	By Balance b/d	20,700
		30,000	Dec. 31 Dec. 31	By Depreciation A/c By Depreciation Insurance Policy A/c	20,700 6,900 2,400
		30,000			30,000

6. Revaluation Method:

According to this method, the asset is valued at the end of every year. In cse, there is increase in the value of the asset concerned that is not taken into account. If the value has decreased, that is treated as revenue loss and shown as depreciation. Thus the difference between its original book value and the revaluated amount is taken as depreciation for that year. For instance, the value of the loose tools was Rs. 11,000 at the beginning of the year. At the end of the year, it was revalued at Rs. 9,200. The difference of Rs. 1800 will be taken as the amount of depreciation.

The revaluation method can only be used in the case of assets such as loose tools, livestock and the like.

Journal Entries:

In this method, at the end of each year, the following entry are passed.

- Depreciation A/c Dr.

  To Asset A/c

  (Being depreciation of asset)

- Profit and Loss A/c Dr.

To Depreciation A/c

(Being transfer of depreciation to P & L A/c)

Example: 10

On 1st Jan 2006, Malvolio Ltd had live stock of Rs. 5,000 on 10th March and 14th September, 2006 he purchased further live-stock of Rs. 1,200 and Rs. 700 respectively. On 31st December, 2006 livestock was valued at Rs. 5,800. Prepare Live-stock A/c for the year 2006.

Solution:

Date	Particulars	Amount	Date	Particulars	Amount
2006			2006		
Jan. 1	To Balance A/c	5,000	Dec. 31	By Depreciation	1,100
Mar. 10	To Cash A/c	1,200	Dec. 31	By Balance c/d	5,800
Sep. 14	To Cash A/c	700			
		6,900			6,900

7. Depletion Unit Method:

This method is applicable to wasting assets such as mines, quarries, and the like where the output for each year depends on the quantity extracted. In this method, depreciation is calculated by making as estimate in advance of the total quantity to be extracted over its life and then the cost of the asset is apportioned over the periods of the asset in proportion to the rate of extraction.

For example, suppose a mine is acquired for Rs. 10,00,000 and it is estimated that 2,50,000 tonnes of coal can be extracted over its life. Therefore, the rate of depreciation per tonne of coal is Rs. 10,00,000/2,50,000 = Rs. If 50,000 tonnes are extracted in a year, then the depreciation will be Rs. 50,000 x 4 = Rs. 2, 00,000.

Example: 11

On January 1st, 2005, a mine was taken on lease for a period of 50 years for Rs. 2,00,000 with estimation that a total of 5,00,000 tonnes of coal shall be raised from this mine and thereafter it will be exhausted.

The output in 2005 & 2006 was 500 tonnes and 8000 tonnes respectively. Prepare Mine Account for two years, providing depreciation according to depletion method.

Solution:

MINE ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
2005 Jan. 1	To Cash A/c	2,00,000	2005 Dec. 31	By Depreciation A/c	200
2006			Dec. 31	By Balance c/d	1,99,800
		2,00,000			2,00,000
2006 Jan. 1	To Balance b/d	1,99,800	2006 Dec. 31	By Depreciation A/c	3,200
			Dec. 31	By Balance c/d	1,99,600
		1,99,800			1,99,800

Calculation of Depreciation:

Year 2005 – $\frac{200000 \times 500}{500000}$ = Rs 200

Year 2006 – $\frac{200000 \times 8000}{500000}$ = Rs 3200

Machine Hour Rate Method:

This is a method of providing depreciation on annual machine hours in use compared with total anticipated machine hours over the life of the machine. Hence, it is necessary to estimate the total effective working hours (estimated hours less idle time) during the whole life of the machine and to divide at an hourly rate of depreciation. For example a machine costs Rs. 50,000 with an estimated residual value of Rs. 10,000. The expected effective working hours during its life are 20,000. The depreciation charge per machine hour will be.

Machine Hour Rate = $\frac{\text{Cost of Machine – Scrap Value}}{\text{Effective Working Hours}}$

Therefore, depreciation rate machine hour is = $\frac{\text{Rs. } 50,000 - 10,000}{20,000}$ = Rs. 2

Under this method, each period is charged with depreciation to the extent of the use of machine. But this method misses a vital point. i.e., depreciation also takes place even when a machine is not in use.

Example: 12

On 1st January 2004, a machine was purchased for Rs. 12,000 and its estimated life was 30,000 hours with residual value of Rs. 2000. The machine worked for 2700 hours in first year, 2,400 hours in second year and 3000 hours in the third year. Prepare machine Account for first three years providing depreciation according to machine hour method.

Solution:

MACHINE ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
2004			2004		
Jan. 1	To Cash A/c	12,000	Dec. 31	By Depreciation A/c	900
			Dec. 31	By Balance c/d	11,100
		12,000			12,000
2005			2005		
Jan. 1	To Balance b/d	11,100	Dec. 31	By Depreciation A/c	800
			Dec. 31	By Balance c/d	10,300
		11,100			11,100
2006			2006		
Jan. 1	To Balance c/d	10,300	Dec. 31	By Depreciation A/c	1,000
			Dec. 31	By Balance c/d	9,300
		10,300			10,300

Note:- Rate of Depreciation per hour $= \frac{12000 - 2000}{30000} =$ Rs. 1/3

Depreciation in 2004 = 1/3 × 2700 = Rs. 900

Depreciation in 2005 = 1/3 × 2400 = Rs. 800

Depreciation in 2004 = 1/3 × 3000 = Rs. 1000

The Sum of the Year's Digits Method:

In this method, first the scrap value of the asset, if any, is subtracted from its cost. Then with the help of a fraction the depreciation of every year is found out. In the fraction the denominator is obtained by adding the digits of all years, and the numerator is the digit of the related year written in reverse order. Therefore, the depreciation value diminishes every year in this method.

Example: 13

On January 1st, 2004 a machine was purchased for Rs. 14,000, the life of which was 3 years. The residual value of machine is Rs. 2,000. Prepare machine account providing depreciation according to the sum of the year's digit method.

Solution:

Total amount of depreciation Rs = (14,000 – 2000)

= Rs. 12,000

COMPUTATION OF THE AMOUNT OF DEPRECIATION

Year	Digits	Depreciation
2004	3	12000 × 3/6 = Rs. 6000
2005	2	12000 × 2/6 = Rs. 4000
2006	1	12000 × 1/3 = Rs. 2000

MACHINE ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
2004 Jan. 1	To Cash A/c	14,000	2004 Dec. 31 Dec. 31	By Depreciation A/c By Balance c/d	6,000 8,000
		14,000			14,000
2005 Jan. 1	To Balance c/d	8,000	2005 Dec. 31 Dec. 31	By Depreciation A/c By Balance c/d	4,000 4,000
2006 Jan. 1		8,000	2006		8,000
	To Balance b/d		Dec. 31 Dec. 31	By Depreciation	2,000

		4,000		A/c By Cash A/c	2,000
		4,000			4,000

19.7 SUMMARY

In accountancy, **depreciation** refers to two aspects of the same concept:

1. the decrease in value of assets (fair value depreciation), and
2. the allocation of the cost of assets to periods in which the assets are used (depreciation with the matching principle).

The former affects the balance sheet of a business or entity, and the latter affects the net income that they report. Generally the cost is allocated, as depreciation expense, among the periods in which the asset is expected to be used. This expense is recognized by businesses for financial reporting and tax purposes. Methods of computing depreciation, and the periods over which assets are depreciated, may vary between asset types within the same business and may vary for tax purposes. These may be specified by law or accounting standards, which may vary by country. There are several standard methods of computing depreciation expense, including fixed percentage, straight line, and declining balance methods. Depreciation expense generally begins when the asset is placed in service. For example, a depreciation expense of 100 per year for 5 years may be recognized for an asset costing 500.

19.8 LONG ANSWER TYPE QUESTIONS

Q.1 What is Depreciation? What are the causes of Depreciation?

Q.2 What are the various methods of calculating Depreciation?

Q.3 Distinguish between 'Straight line Method' and Written Down Value Method?

Q.4 What are the factors to be taken into consideration in selecting a depreciation method?

Q.5 Describe the following methods.

(a) Annuity Method. (b) Sinking Fund. (C) Revaluation Method.

19.9 NUMERICAL QUESTIONS

Q.1 **Original Cost Method:--**On 1st January, 2002 a company purchased asset for Rs. 80,000. The estimated life of the asset is 10 years after which its breakup value will be Rs. 8,000 Find out the rate of depreciation under straight line method and prepare the asset account for the first four years.

[Ans.—Rate of Depreciation 9% per annum, Balance of Asset accounts Rs. 51,200].

Q.2 On 1.1.2004, a company purchased a machine for Rs. 1, 00,000. It was decided to write-off 10% depreciation under straight line method, estimating the life of the machine at 10 years and scrap value at Rs. 10,000. You are required to prepare Machinery Account up to 31.12.06 and also show the provision for depreciation account for the same period.

[Ans.—Depreciation p.a. Rs. 9,000; Net Book Value as on 31.2.06 Rs. 73,000].

Q.3 On 1st July, 2000 Mohan and Company purchased machinery worth Rs. 40,000 On 1st July, 2012 it buys addition machinery worth Rs. 10,000. On 30th June, 2003 half of machinery purchased on 1st July, 2000 is sold for Rs. 8,200. The Company writes off 10% depreciation per annum on the original cost The accounts are closed every year on 31st December. Show the Machinery Account for four years.

[Ans.—Loss on sale 5,800, Balance of Machinery Account on 31st December 2003 Rs. 21,500].

Diminishing Balance Method

Q.4 A Plant is purchased for Rs. 6,00,000 on 1st April, 2003. Some additions to the Plant are made on 1st July, 2003 for Rs. 1,00,000 Depreciation on the Diminishing Balance Method is to be written off at 10% p.a. in 2003, at 15% p.a. in 2004 and 20% in 2005 and 2006. The books are closed on 31st December each year.

[Ans.—Depreciation (total): 2003 Rs. 50,000; 2004 Rs. 97,500 2005 Rs. 1, 10,500; 2006 Rs. 88,400; Balance of Machinery Account on 31.12.2007 Rs. 3, 53,600].

Q.5 On 1st Aprtil, 2002 Gudan Paper Limited purchased a Plant for Rs. 1, 50,000 and paid Rs. 10,000 as freight on the carriage. Depreciation was provided at 10% p.a. on written down value method on this plant. On 1st July, 2005, this plant was sold for Rs. 80,000. Prepare Plant Account from 2002 to 2005.

[Ans.—Loss on sale of Amount Plant Rs. 33,886].

Q.6 A Company purchased machinery for Rs. 50,000 on 1st July, 2003 another machinery costing Rs. 10,000 was purchased on 1st Sept. 2004. On 31st December, 2005 the machinery purchased in 2003 was sold at a loss of Rs. 5,000. The Company charges depreciation at the rate of 15% p.a. on diminishing balance method Accounts are closed on 31st December every year. Prepare Machinery Account for three years.

[Ans.—Sale price of Machinery Rs. 26,415.62; Balance of Machinery A/c on 31st December 2005 Rs. 8,075].

Prospective Change in the Method of Depreciation:

Q.7 On 1st July, 2003, a company purchased a plant for Rs. 20,000. Depreciation was provided at 10% p.a. on straight-line method on 31st December every year. With effect from 1.1.2005, the company decided to change the method of depreciation to Diminishing Balance Method @ 15% p.a. On 1.7.2006. the plant was sold for Rs. 12,000. Prepare Plant Account from 2013 to 2006.

[Ans.—Loss on sale of Plant Rs. 1,366.25].

Q.8 A firm purchased on 1st January 2003, machinery for Rs. 58,200 and additional machinery costing Rs. 20,000 was purchased on 1st July, 2005 the machinery purchased on 1st January, 2003 was sold for Rs. 28.600 and on the same date, fresh machinery was purchased at a cost of Rs. 40,000. Depreciation was provided annually on 31st December @ 10% on Written Down value. In 2006, however, the firm changed this method of providing depreciation and adopted the method of providing depreciation @ 5% p.a. on the original cost of machinery. Give Machinery Account as it would stand at the end of each year from 2003 to 2006.

[Ans.—Loss on sale of Machinery Rs. 27,500; Depreciation for 2006 Rs. 3,000 (under new method); Net book value Rs. 48,380 on 31.12.06].

Q.9 Mohinder Carpet Ltd. purchased a Machine for Rs. 1, 40,000 on 1st April 2002 and spent Rs. 20,000 as octroi and erection charges. The company charges depreciation at 10% p.a. according to the Reducing Balance method. From December, 2004, the company decided to charge depreciation @ 10% p.a. according to Fixed Installment method. The machine was sold for a sum of Rs. 60,000 at the end of 2005. Prepare Machinery Account from 2002 to 2005.

[Ans.—Loss on Sale of Machinery Rs. 41,200].

Retrospective Change in the Method of Depreciation:

Q.10 Shyam Enterprises depreciates its machinery @ 10% p.a. on reducing balance. On 1.1.2002, the balance in machinery account was Rs. 97,200.

During the year 2002, a machine was purchased on 1.1.2000 for Rs. 8,000 was sold for Rs. 4,500 on 1.7.2002. A new machine was brought on the same date for Rs. 15,800. On 1st January, 2002, the concern changed the method of depreciation from reducing balance method to straight line method with retrospective effect from 2000 with no change in the rate.

Show the Machinery Account for the year ending 31st December, 2002.

[Ans.—Loss on sale of machinery Rs. 1,656; Extra depreciation due to change in method Rs. 1,120; Balance of Machinery Account Rs. 93,410]

Q.11 Sameer Ltd. which depreciates its machinery at 10% p.a. on Diminishing Balance Method had on 1.1.2005, Rs. 9, 72,000 on the debit side of the Machinery Account. During the year 2005. Machinery purchased on

1.1.2003 for Rs. 80,000 was sold for Rs. 45,000 on 1.7.2005 and a new machinery at a cost of Rs. 1,50,000 was purchased and installed on the same date, installation charges being Rs. 8,000. The company wanted to change the method of depreciation from Diminishing Balance Method to straight line method, w.e.f. 1.1.2003. Difference of depreciation upto 31.12.2005 to be adjusted. The rate of depreciation remains the same as before. Show Machinery Account.

[Ans.—Loss on sale of machinery Rs. 16,500, Additional depreciation to be charged Rs. 11,200 (Rs. 2,24,000 – Rs. 2,12,800) Net book value on 31.12.2005 Rs. 9,34,100]

Q.12 A firm is willing to change the system of providing depreciation from Diminishing Balance Method to Straight Line Method with retrospective Effect from 1st April, 2005. On 1st April, 2007, Machinery account in the ledger had a debit-balance of Rs. 5, 67,000.

The rate of depreciation would however, remain unchanged. Necessary adjustments for depreciation due to change in method should be made in the year 2007 Rate of Depreciation 10% p.a. You are further informed that new Machinery were purchased on 1st October, 2007 at a cost of 60,000. Prepare Machinery Account.

[Ans.—Original cost on 1st April, 2005 Rs. 7,00,000; Extra depreciation due to change in method Rs. 7,000; Balance of Machinery Account on 31st March, 2007 Rs. 5,47,000]

UNIT-20 PROVISIONS AND RESERVES

Objective :

After studying this unit you will be able to

- Know the Meaning and Definition of Provision and Reserves
- Need and Causes of Depreciation
- Factors Determining the Amount of Depreciation
- Methods of Calculating Depreciation,

Structure :

20.1 PROVISIONS

In financial accounting, a provision is an account which records a present liability of an entity to another entity. The recording of the liability affects both the current liability side of an entity's balance sheet as well as an appropriate expense account in the entity's income statement. Under the International Financial Reporting Standards (IFRS) a provision is a liability, while under United States Generally Accepted Accounting Principles (GAAP) it is an expense.

A provision can be a liability of uncertain timing or amount. A liability, in turn, is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The term **reserve** is most commonly used to describe any part of shareholders' equity, except for basic share capital. In nonprofit accounting, an "operating reserve" is commonly used to refer to unrestricted cash on hand available to sustain an organization, and nonprofit boards usually specify a target of maintaining several months of operating cash or a percentage of their annual income, called an Operating Reserve Ratio.

Sometimes, reserve is used in the sense of the term provision; (such a use, however, is inconsistent with the terminology suggested by International Accounting Standards Board).

In order to strengthen the financial position of the business and with a view to meeting all eventualities—both expected and unexpected, it is desirable that the entire profit should not be distributed among their owners. Some portion of the profit should be kept in the business for meeting the known as well as unknown liabilities in future. This is done, by making provisions and creating reserves out of current year's profits at the time of preparation of final accounts.

The terms 'provisions' and 'reserve' are quite distinct from each other and cannot be used interchangeably. The law has defined the two terms clearly.

Meaning:-

According to the Companies Act the term 'Provision' refers to any of the following amounts:-

(i) The amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets; or

(ii) The amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy.

It should be clearly understood that if the amount of a known liability can be determined with reasonable accuracy, it must be classified as an outright liability and not a provision. Also if any excess provision is made knowingly or intentionally, the amount in excess of the actual need will be treated as 'reserve'.

20.1.1 CHARACTERISTICS OR FEATURES OF PROVISIONS

- Provision is made to meet a known liability.
- The liability is known but the amount of such liability cannot be determined with reasonable accuracy. For example, it is almost certain that some debts will prove irrecoverable but the exact amount of bad-debts cannot be predicted with certainty.
- Provision is a charge against profits and as such reduces the profits of the year in which it is created. The loss when actually occurs will be written off against such provisions and thus the profits of the year in which such loss occurs will not be affected.

20.1.2 PURPOSE OR IMPORTANCE OF PROVISIONS

- **To ascertain the true net profit of the business-** In order to ascertain the true profit of a business it is necessary that all expenses pertaining to that all expenses pertaining to that year, whether paid or outstanding, must be debited to Profit and Loss account and a provision should also be made for expenses or liabilities the amount of which cannot be estimated with reasonable accuracy. For example, the provision should be made for doubtful debts, because the amount of such bad debts cannot be estimated very accurately.

- **To ascertain the true financial position of the business:-** The Balance Sheet will depict the true and fair view of the financial positi

- on of the business only if adequate provision is made for all the anticipated losses and expenses.

- **To provide for known losses in the future:-** Funds will be required to meet the losses and liabilities that are likely to occur in the near future. As such, provisions are made to provide funds for meeting those losses such as provisions for taxation, provision for repairs, provision for damages likely to arise from a pending suit and such others.

- **For the equitable distribution of expenses:-** For example, if a machine is estimated to run for 10 years and the total amount of repairs expected to be incurred during its entire life span is Rs. 10,000 a 'provision for repairs a/c' will be created by debiting Rs. 1,000 to each year's Profit & Loss Account. Actual expenses of repairs incurred each year will be debited to this account. Hence, it will put equal burden on the Profit & Loss Account of each year in respect of expenses of repairs which will be very light in the earlier years but definitely heavy in the later years.

20.2 RESERVES

20.2.1 MEANING

Reserves mean amounts set aside out of profits and other surpluses to meet future uncertainties. In other words, a reserve is meant for meeting any unknown liability or loss in the future. According to William Pickles, ("Reserves mean the amounts set aside out of profits and other surpluses, which are not earmarked in any way to meet any particular liability, known to exist on the date of the Balance Sheet."

Examples of reserves are: (1) General Reserve, (2) Capital Reserve, (3) Dividend Equalization Reserve, (4) Investment Fluctuation Fund, (5) Workmen Compensation Fund, (6) Reserve for Redemption of Debentures. It should be clearly understood that the amount of reserve does not represent any expense or loss and as such it is not debited to Profit & Loss Account. Creation of reserve does not reduce the net profits but only reduces the divisible profits. It is an appropriation of profits and hence after ascertaining the net profits it is debited to Profit & Loss Appropriation Account.

20.2.2 CHARACTERISTICS OR FEATURES OF RESERVES

- It is created out of net profits or divisible profits. As such the reserves are also termed as 'Retained Earnings' or 'Undistributed Profits'.
- Creation of reserves is not a legal necessity. It is created voluntarily for strengthening the general financial position of the business and for meeting an unanticipated situation in the future.
- It is not created to meet any known liability or depreciation in the value of assets but for meeting an unknown liability or loss in the future.
- Reserves represent accumulated or undistributed profits and as such they belong to the proprietors just as capital does. They are available for distribution as dividends among shareholders and just as the capital is shown on the liabilities side of the Balance Sheet, they are also shown on the liabilities side.
- When the amount of reserve is invested in outside securities it is known as 'reserve fund'.

20.3 PURPOSE OR IMPORTANCE OF RESERVES

- **Helpful in meeting the unforeseen liability or loss:-** If any unforeseen or abnormal loss arises in the future, reserves can be utilized to meet such eventualities.
- **Helpful in strengthening the financial position of the business:** Reserves are undistributed or accumulated profits and technically known as 'ploughing back of profit'. It is a source of internal financing of the expansion of business. In case the reserves had not been maintained the profit would have been distributed as dividend among shareholders.
- **Equalisation ofdividends over the year: -** Good will of a Company depends upon maintaining a uniform rate of dividend from year to year and also to increase the dividend steadily. Reserves help the directors to achieve this objective because in the periods of inadequacy of profits, the amount can be withdrawn from reserves. Sometimes a reserve known as 'dividend equalization reserve' is also created for the specific purpose of equalizing the rate of dividend.
- **To provide funds for meeting a specific liability:** Sometimes a reserve is created for a specific purpose such as 'Debenture Redemption Fund' for the payment of debentures. For example, if we need Rs. 5 crore for the repayment of debentures after 10 years, a fund is created for this purpose by transferring a fixed amount from the divisible profits each year. The funds so accumulated may also be invested outside the business in such a way that after 10 years Rs. 5 crore will become available for the payment of debentures. It will facilitate the payment of such a big sum in one go.

20.4 DIFFERENCE BETWEEN PROVISION AND RESERVE

Basis of Difference	Provision	Reserve
1. Meaning	It is created to meet a known liability.	It is created to meet an unknown liability.
2. Necessity	Creation of provision is a legal necessity. Provisions have to be provided for even if there are no profits. Thus provision is a charge against profits.	Creation of reserves is discretionary. If can be created only if adequate profits have been earned. Thus reserve is an appropriation of profits.
3. Object	The object is to provide for depreciation, doubtful debts and other specific liabilities.	The object of reserves is to strengthen the financial position of the business.
4. Mode of Creation	It is created by debiting to P & L A/c Hence; net profit cannot be calculated unless all provisions have been debited to P & L A/c.	It is created not by debiting to P & L A/c but through P & L Appropriation A/c. As such, it is created after the calculation of net profit.
5. Investment outside the business.	Provisions are never invested outside the business.	Reserves may be invested outside the business.
6. Presentation in Balance Sheet.	It is either shown on the assets side by way of deduction from the asset for which it is created or as a distinct item on the liabilities side.	It is shown on the liabilities side under the head Reserves and Surplus.
7. Utilization for dividends.	It cannot be utilized for distribution as dividends among shareholders.	It can be utilized for distribution as dividends among shareholders.
8. Utilization for other purposes.	It is created to provide for a specific loss and hence can only be used for meeting that loss.	It is not created to provide for a specific loss and hence can be usedfor any purpose.

20.5 TYPES OF RESERVES-RESERVES CAN BE SEPARATED AS UNDER

1. Revenue Reserves
2. Capital Reserves

Revenue Reserves are of two types-

a. General Reserves
b. Specific Reserves

Revenue Reserves:- These reserves come into existence out of profits which have been earned in the course of day to-day business operation. Therefore, the revenue reserves represent undistributed profits and as such are available for the distribution of dividends.

Kohler has defined revenue reserves as, ("that portion, or any detail thereof, of the net worth or total equity of an enterprise representing retained earnings available for withdrawal by proprietors.")

Revenue reserves may be of the following two types:-

(A) General Reserve:- Usually, (the businessmen do not withdraw the entire profits from the business but retain a part of it in the business to meet unforeseen future uncertainties.) Profits so retained in the business for 'a rainy day' are known as 'General Reserve'. Similarly, Companies also do not distribute the entire profits as dividends but keep aside a part of it in the form of General Reserve. Such reserves are also termed as 'Contingency Reserves' or 'Free Reserves' because these are not created for any specific purpose and can be freely used for any purpose.

Objectives:- General Reserves may be created or utilized for any of the following purposes:

- For meeting unforeseen losses.
- For the strengthening of financial position of business.
- For expansion of business through internal resources or ploughing back of profits.
- For equalization of dividends over years, in case of Companies.

It is not compulsory and binding upon the business enterprises to maintain general reserves. Such reservesmay be created in the year in which the profits are sufficient and the management things it advisable to do so.

General Reserves are shown on the liabilities side of the Balance Sheet under the head 'Owner's Equity'.

(B) Specific Reserve:- Such a reserve is created for a specific purpose and can be utilized only for that purpose. Examples of specific reserves are:-

(I) Dividend Equalization Reserve

(II) Reserve for Replacement of Asset:- Such a reserve is created to provide finances for the replacement of an asset at the end of its serviceable life. (The amount of annual depreciation charges on assets is only capable of providing the original cost of the asset but the replacement of the asset will require a large sum of money due to the inflationary trend of prices. As such, a 'reserve for replacement of asset' is created to provide for the extra amount required for the purchase of the new asset) For example, if an asset was purchased 10 years ago at a cost of Rs. 10 Lac and if the depreciation has been provided @ 10% on the original cost, it will provide only a sum of Rs. 10 Lac. But, suppose, the current price of the asset is Rs. 40 Lac, an additional sum of Rs. 30 Lac will be required for purchasing a new asset. Therefore, the reserve is created for providing this additional sum.

'Reserve for Replacement of Asset' is created by annually transferring a certain amount from Profit & Loss Appropriation A/c. Following entry is passed for this purpose:

Profit & Loss Appropriation A/c Dr.

To Asset Replacement Reserve A/c

(Amount transferred out of divisible profits)

The amount of replacement reserve is either kept and utilized in the business itself or is invested in outside securities bearing interest at a pre determined rate. When this reserve is invested in outside securities it is known as 'reserve fund'. Such a reserve is created out of divisible profits. In other words, instead of declaring higher dividends the amount is transferred to replacement reserve. If such a reserve had not been created,the profit would have been distributed as dividend and the amount would have gone outside the business. The amount thus saved is accumulated from year to year and is utilized for the specific purpose of replacement of the asset. 'Reserve for Replacement of Asset A/c' is closed by transferring it to 'General Reserve A/c' at the end.

(III) Investment Fluctuation Fund: It is created to provide for decline in the value of investments due to market fluctuations.

(IV) **Workmen Compensation Fund:-** It is created to meet compensation payable to workers in case of unexpected or unknown event of an accident.

(V) **Debenture Redemption Reserve:-** It is created to provide funds for the redemption i.e., repayment of debentures.

Capital Reserves:- (In additions to the normal profits, capital profits are also earned in the business from many sources. The reserves created out of such capital profits are known as Capital Reserves.) Such reserves generally, are not available for distribution as cash dividend among the shareholders of a Company. Profits received from the following sources are termed as capital profits:-

- Profits on the sale of fixed assets.
- Profits on the revaluation of fixed assets and liabilities.
- Premiums received on issue of Shares or Debentures.
- Profit on the purchase of a running business.
- Profit prior to the incorporation of a Company.
- Profit from the reissue of forfeited shares.
- Profit on redemption of debentures.

All the Capital profits mentioned above should be treated as Capital Reserves.

Capital reserves are used to write off Capital losses and for the issue of fully paid bonus shares. Usually, the capital reserves are not available for distribution as cash dividends. Some capital reserves can however be utilized to distribute dividends subject to fulfillment of the following conditions:-

- Articles of the Company must not prohibit such dividend.
- Capital profits must have been realized in cash.
- Such profit remains after a fair revaluation of assets and liabilities.

All the same, it would be a prudent policy on the part of the management not to distribute such profits. They should be kept in the business to strengthen its financial position.

Distinction between Revenue Reserves and Capital Reserves

Basis of Distinction	**Revenue Reserves**	**Capital Reserves**
1. Source of Creation	These reserves are created out of revenue profits which arise from the normal operating activities of the business and are otherwise available for distribution of	These reserves are created out of capital profits, which do not arise from the normal operating activities of the business and are not available for

	dividends.	distribution of dividends.
2. Usage	A specific reserve can be utilized only for the earmarked purpose while a general reserve can be utilized for any purpose including distribution of dividends to shareholders without any pre-conditions.	Normally, these reserves cannot be utilized for distribution of dividends to shareholders. However, some capital reserves can be utilized to distribute dividends subject to fulfillment of certain conditions laid down by Companies Act.
3. Purpose	These reserves are created for meeting unforeseen losses and for strengthening the financial position of business.	These reserves are created to meet Capital losses or may be used for purposes laid down by Companies Act.

Secret Reserves:

A secret reserve is one which is not disclosed by the Balance Sheet. These reserves are created by showing profit at figure much lower than actual and by showing the assets at a lower figure and liabilities at a higher figure. When secret reserves exist, the actual position of the firm is much better than what is disclosed by the Balance Sheet. Secret reserves may be created in the following ways:

- Writing off excessive depreciation;
- Charging Capital expenditure (such as addition to assets) to Profit & Loss Account;
- Treating revenue receipt as a capital receipt (such as rent received credited to Building Account);
- Undervaluation of assets (such as undervaluation of closing stock);
- Showing an actual asset as a contingent asset;
- Showing a contingent liability as an actual liability;
- Suppressing the sales;
- Creating excessive or unnecessary provision for doubtful debts and other contingencies.

Advantages of Secret Reserves:

- **Financial Stability:** Creation of secret reserves strengthens the financial position of the enterprise without disclosing this fact to the shareholders or the public.

- **Helpful in Absorbing Unforeseen Losses:** The presence of secret reserves enable such concerns to absorb any unexpected losses without any public discomfiture.

- **Regularity of Dividends:** Such reverves help the enterprise in maintaining the rate of dividend during adverse treading conditions without disclosing this fact to shareholders or the public.

- **Avoidance of Competition:** Because of concealment of actual profitability of the enterprise, the entry of the competing firms in the particular line of business is avoided.

Disadvantages of Secret Reserves:

- **Unfair Presentation of Financial Statements:** Profit & Loss Account fails to disclose true profit and the Balance Sheet fails to disclose a true and fair view of the financial position of the enterprise.

- **Loss to Shareholders:** Shareholders who wish to sell their shares may not get actual price of their shares because of understatement of profits and financial positions of the enterprise.

- **Misuse by Management:** Fraudulent managements may take undue advantage by creating secret reserves. Profits may be suppressed to enable them to buy the shares of the Company at a lower price and then the profits may be enhanced by eliminatingthe secret reserves to enable them to sell the shares at a higher price.

- **Cover for Misdeeds of Management:** Secret reserves may be utilized by management to cover their mistakes or misdeeds.

  The creation of secret reserves is not allowed under the Companies Act, 1956 as it requires a full disclosure of material facts and significant accounting policies followed in preparing financial statements.

20.6 SUMMARY

In general reserves are for current and future expenses that cannot currently be deducted, ie reserve for bad debts, for reserve for litigation. The reserve must be factual and not a supposition. Surplus is retained earnings accumulated from current or prior period. At the end of an accounting period the company may decide to transfer part of the profits to a reserve and retain the balance in the profit and loss account. The reserve created out of profits transferred from profit and loss account is called general reserve. The balance in the profit and loss account is called a surplus (and will be shown under this head in the balance sheet. The company can use the general reserve for various purposes including issue of bonus shares to shareholders and payment of dividend when profits are insufficient.

20.7 QUESTIONS

1. What are provisions? Explain in detail.
2. Explain in detail why provisions are created.
3. What are reserves?
4. Explain the various types of reserves.
5. What are secret reserves?

ROUGH WORK