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ADVANCED ACCOUNTING

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SYLLABI-BOOK MAPPING TABLE

Advanced Accounting

Syllabi	Mapping in Book
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INTRODUCTION

Good accountants make good finance managers. This is wholly true since accounting is one of the most important tools for modern managers, providing quantitative information, primarily of financial nature, necessary for making vital economic decisions. Both accounting and finance are growing and developing subjects and as such, accounting and financial concepts, procedures and techniques are also constantly being reviewed and revised. A clear exposition of these concepts, procedures and techniques is a must for every business executive. The universities and professional institutions which prepare young men and women for careers in business and industry have, therefore, a solemn duty to perform. Their courses must be constantly updated so that they meet the growing and dynamic demands of business and industry.

This book, Advanced Accounting, provides detailed information on all important aspects of accounting. It is divided into fourteen units with each unit being presented in the SIM format, wherein a unit begins with an Introduction to the topic followed by an outline of the Objectives. The topic is then explained in detail but in an organized manner to facilitate understanding. The content is presented in simple language interspersed with 'Check Your Progress' questions to test the reader's understanding. At the end of each unit, a Summary, a list of Key Terms, Answers to 'Check Your Progress' as well as Self-Assessment Questions and Exercises are provided for recapitulation and practice.

BLOCK - I

BASIC ACCOUNTING CONCEPTS

UNIT 1 ACCOUNTING: MEANING, CONCEPTS, PRINCIPLES AND CONVENTIONS

Structure

1.0 INTRODUCTION

Accounting has rightly been termed as the language of the business. The basic function of a language is to serve as a means of communication. Accounting also serves this function. It communicates the result of business operations to various parties who have some stake in the business, *viz.,* the proprietor, creditors, investors, Government and other agencies. Though accounting is generally associated with business but it is not only business which makes use of accounting. Persons like housewives, Government and other individuals also make use of accounting. For example, a housewife has to keep a record of the money received and spent by her during a particular period. She can record here receipts of money on one page of her "household diary", while payments for different items such as milk, food, clothing, house, education, etc., on some other page or pages of her diary in a chronological order. Such a record will help her in knowing about:

(*i*) The sources from which she received cash and the purposes for which it was utilised.

(*ii*) Whether her receipts are more than her payments or *vice versa*?

(*iii*) The balance of cash in hand or deficit, if any, at the end of a period.

In case the housewife records her transactions regularly, she can collect valuable information about the nature of her receipts and payments. For example, she can find out the total amount spent by her during a period (say, a year) on different items, say milk, food, education, entertainment, etc. Similarly, she can find the sources of her receipts such as salary of her husband, rent from property, cash gifts from her near relations, etc. Thus, at the end of a period (say, a year) she can see for herself about her financial position, i.e., what she owns and what she owes. This will help her in planning her future income and expenses (or making out a budget) to a great extent.

The need for accounting is all the more greater for a person who is running a business. He knows: (i) What he owns? (ii) What he owes? (iii) Whether he has earned a profit or suffered a loss on account of running a business? (iv) What is his financial position, i.e., whether he will be in a position to meet all his commitments in the near future or he is in the process of becoming a bankrupt.

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

Accounting principles[1] may be defined as those rules of action adopted by the accountants universally while recording accounting transaction. “They are a body of doctrines commonly associated with the theory and procedures of accounting, serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist”. These principles can be classified into two categories:

(*i*) Accounting Concepts[2]

(*ii*) Accounting Conventions

1.1 OBJECTIVES

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

- Discuss the meaning and differences between Book-Keeping and accounting

[1]. also termed as ‘Accounting Standards’.
[2]. also termed as ‘Accounting Postulates’.

- Describe the concepts of accounting and accountancy
- Explain the various users of accounting information
- Identify the objectives of accounting
- Examine the accounting system and process
- Explain the limitation of accounting
- Explain the meaning and types of accounting concepts
- Discuss the accounting convention and its types
- Examine the accounting principles
- Identify the accounting standards

1.2 MEANING AND SCOPE

Some people take book-keeping and accounting as synonymous terms, but they are different from each other. Book-keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner. A book-keeper may be responsible for keeping all the records of a business or only of a minor segment, such as a position of the Customers' accounts in a departmental store. A substantial portion of the book-keeper's work is of a clerical nature and is increasingly being accomplished through the use of mechanical and electronical devices.

Accounting is primarily concerned with designing the systems for recording, classifying and summarizing the recorded data and interpreting them for internal and external endusers. Accountants often direct and review the work of the book-keepers. The larger the firm, the greater is the responsibility of the accountant. The work of an accountant in the beginning may include some book-keeping. An accountant is required to have a much higher level of knowledge, conceptual understanding and analytical skill than what is required for a book-keeper.

The difference between book-keeping and accounting can be well understood with the help of the following example:

If *A* sells goods to *B* on credit, the only fundamental principle involved is of "dual aspect" and to give a true picture of the transaction, both the aspects must be considered. On the one hand, *A* has lost one asset, *i.e.,* good and on the other hand, he has obtained another asset, *i.e.,* a "debt due from *B*". The book-keeper should debit *B*'s account in *A*'s books and credit the sales account. However, if at the end of a year, *A* has got some stock of goods with him, they should be properly valued in order to ascertain the true profit of the business. The principle to be followed in valuing the stock and many adjustment that will have to be made before the books of account can be closed and true profit or loss can be ascertained, are all matters of accounting. Thus, book-keeping is more of a routine work and a book-keeper, if instructed properly, can record the routine transactions quite efficiently even if he does not know much of accounting principles.

Is Accounting A 'Science' or An 'Art'?

Any organized knowledge based on certain basic principles is a 'science'. Accounting is also a science. It is a organized knowledge based on scientific principles which have been developed as result of study and experience. Of course, accounting cannot be termed as a "perfect science" like Physics or Chemistry where experiments can be carried and perfect conclusions can be drawn. It is a social science depending much on human behaviour and other social and economic factors. Thus, perfect conclusions cannot be drawn. Some people, therefore, though not very correctly, do not take accounting as a science.

Art is the technique which helps us in achieving our desired objective. Accounting is definitely an art. The American Institute of Certified Public Accountants also defines accounting as "the art of recording, classifying and summarizing the financial transactions". Accounting helps in achieving our desired objective of maintaining proper accounts, *i.e.,* to know the profitability and the financial position of the business, by maintaining proper accounts.

1.2.1 Accounting and Accountancy

Honestly speaking, in today's world, there is not much difference between accounting and accountancy. The terms have become pretty much interchangeable. Accounting is traditionally one of the three principles of accountancy (the others were bookkeeping and auditing), which was the application of reading and maintaining the financial records of said company. Traditionally, accountancy is the parent term for the entire field and accounting was a specific duty of an accountant. Accountancy is referred to as the actual process of communicating information about the financial state of a company to its shareholders, usually in the form of financial statements, which show the assets and resources under the company's control in monetary terms.

1.2.2 Various Users of Accounting Information

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

1. **Proprietors** A business is done with the objective of making profit. Its profitability and financial soundness are, therefore, matters of prime importance to the proprietors who have invested their money in the business.
2. **Managers** In a sole proprietary business, usually the proprietor is the manager. In case of a partnership business either some or all the partners

participate in the management of the business. They, therefore, act both as managers as well as owners. In case of joint stock companies, the relationship between ownership and management becomes all the more remote. In most cases the shareholders act merely as rentiers of capital and the management of the company passes into the hands of professional managers. The accounting disclosures greatly help them in knowing about what has happened and what should be done to improve the profitability and financial position of the enterprise in the period to come.

3. **Creditors** Creditors are the persons who have extended credit to the company. They are also interested in the financial statements because these will help them in ascertaining whether the enterprise will be in a position to meet its commitment towards them both regarding payment of interest and principal.
4. **Prospective Investors** A person who is contemplating an investment in a business will like to know about its profitability and financial position. A study of the financial statements will help him in this respect.
5. **Government** The Government is interested in the financial statements of business enterprise on account of taxation, labour and corporate laws. If necessary, the Government may ask its officials to examine the accounting records of a business.
6. **Employees** The employees are interested in the financial statements on account of various profit sharing and bonus schemes. Their interest may further increase in case they purchase shares of the companies in which they are employed.
7. **Citizen** An ordinary citizen may be interested in the accounting records of the institutions with which he comes in contact in his daily life, *e.g.,* bank, temple, public utilities such as gas, transport and electricity companies. In a broader sense, he is also interested in the accounts of a government company, a public utility concern etc., as a voter and a tax-payer.

1.2.3 Advantages of Accounting

The following are the main advantages of accounting:

1. **It keeps systematic records** Accounting is done to keep a systematic record of financial transactions. In the absence of accounting there would have been terrific burden on human memory which is most cases would have been impossible to bear.
2. **It protects business properties** Accounting provides protection to business properties from unjustified and unwarranted use. This is possible on account of accounting supplying the following information to the manager or the proprietor.

(*i*) The amount of the propreitor's funds invested in the business.

(*ii*) How much the business has to pay to others?

(*iii*) How much the business has to recover from others?

(*iv*) How much the business has in the form of (*a*) fixed assets, (*b*), cash in hand, (*c*) cash at bank, (*d*) stock of raw materials, work-in-progress and finished goods?

Information about the above matters helps the proprietor in assuming that the funds of the business are not unnecessarily kept idle or under-utilised.

3. **It ascertains the operational profit or loss** Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business. This is done by keeping a proper record of revenues and expenses of a particular period. The Profit and Loss Account is prepared at the end of a period and if the amount of revenue for the period is more than the expenditure incurred in earning that revenue, there is said to be a profit. In case the expenditure exceeds the revenue, there is said to be a loss.

   Profit and Loss Account will help the management, investors, creditors, etc., in knowing whether running of the business has proved to be remunerative or not. In case it has not proved to be remunerative or profitable, the cause of such a state of affairs will be investigated and necessary remedial steps will be taken.

4. **It ascertains the financial position of business** The profit and Loss Account gives the amount of profit or loss made by the business during a particular period. However, it is not enough. The businessman must know about his financial position, *i.e.*, where he stands what he owes and what he owns? This objective is served by the Balance Sheet or Position Statement. The Balance Sheet is a statement of assets and liabilities of the business on a particular date. It serves as barometer for ascertaining the financial health of the business.

5. **It facilitates rational decision making** Accounting these days has taken upon itself the task of collection, analysis and reporting of information at the required points of time to the required levels of authority in order to facilitate rational decision making. The American Accounting Association has also stressed this point while defining the term 'accounting' when it says that accounting is, "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information." Of course, this is by no means an easy task. However, the accounting bodies all over the world and particularly the International Accounting Standards Committee, have been trying to grapple with this problem

and have achieved success in laying down some basic postulates on the basis of which the accounting statements have to be prepared.

1.2.4 Limitations of Accounting

NOTES

Financial accounting well answered the needs of business in the initial stages when the business was not so complex. The growth and complexities of modern business brought out the following limitations of financial accounting:

1. **Provides only limited information** There are now no set patterns of business on account of radical changes in business activities. An expenditure may not bring an immediate advantage to the business but it may have to be incurred because it may bring advantage to the business in the long run or may be necessary simply to sell the name of the business. The management needs a lot of varied information to decide whether on the whole it will be justifiable to incur a particular expenditure or not. Financial accounting fails to provide such information.
2. **Treats figures as single, simple and silent items** Financial accounting fails to make the people realize that accounting figures are not mere isolated phenomena but they represent a chain of purposeful and pertinent events. The role of accountant these days is not only of a book-keeper and auditor, but also that of a financial adviser. Recording of transactions is now the secondary function of the accountant. His primary function now is to analyse and interpret the results.
3. **Provides only a post-mortem record of business transactions** Financial accounting provides only a post-mortem record of business transactions since it records transactions only on historical basis. These days business decisions are made on the basis of estimates and projections rather than historical facts. Of course, past records are helpful in making future projections but they alone are not sufficient. Thus, needs of modern management demand a break-up from the principles and practice of traditional accounting.
4. **Considers only quantifiable information** Financial accounting considers only those factors which are capable of being quantitatively expressed. In modern times, the concept of welfare state has resulted in increased government interference in all sectors of the national economy. The management has, therefore, to take into account government decisions over and above purely commercial considerations. Some of these factors are not capable of being quantitatively expressed and hence their impact is not reflected in financial statements.
5. **Fails to provide informational needs of different levels of management** The shareholders are only rentiers of capital. The business is run in reality by different executives, each an expert in his

area. These executives have powers based on the level of management to which they belong. There are usually three levels of management—top management, middle management and lower management. The type of information required by each level of management is different. The top management is mainly concerned with the policy decisions. They, therefore, are interested in knowing about the soundness of the plans, proper structuring of the organization, proper delegation of authority and its effectiveness. The middle management executives function as coordinators. They must know: (*i*) What happened? (*ii*) Where it happened? and (*iii*) Who is responsible? The lower management people function as operating supervisors. They should get information regarding effectiveness of their operations. The reports submitted to them should give details about the planned performance, actual performance and the deviations with their reasons. Financial accounting does not have a built-in system to provide all such information.

Check Your Progress

1. List some of the users of accounting information.
2. Which accounting tool helps to ascertain the financial position of a business??

1.3 ACCOUNTING SYSTEMS AND PROCESSES

Book-keeping, as explained earlier, is the art of recording pecuniary or business transactions in a regular and systematic manner. This recording of transactions may be done according to any of the following two systems:

1. **Single entry system** An incomplete double entry system can be termed as a single entry system. According to Kohler, "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". This system has been developed by some business houses, who for their convenience, keep only some essential records. Since all records are not kept, the system is not reliable and can be used only by small firms.
2. **Double entry system** The system of 'double entry' book-keeping which is believed to have originated with the Venetian merchants of the fifteenth century, is the only system of recording the two-fold aspect of the transaction. This has been, to some extent, explained while discussing the 'dual aspect concept' earlier in this unit. The system recognises that every transaction has a two-fold effect. If some one receives something then either some other person must have given it, or the first mentioned person must have lost something, or some service etc., must have been rendered by him.

1.3.1 Accounting Equation

The double entry system of book-keeping can very well be explained by the "accounting equation" given below:

Assets = Equities

The properties owned by business are called 'assets'. The rights to the properties are called 'Equities'. Equities may be sub-divided into two principal types: the rights of the creditors and the rights of the owners. The equity of creditors representing debts of the business and are called "liabilities". The equity of owners is called "capital", or proprietorship or owner's equity. Thus:

Assets = Liabilities + Capital

or Capital = Assets – Liabilities

The accounting equation can be understood with the help of the following transactions:

Transaction 1. *A* starts business with a capital of ₹10,000

There are two aspects of the transaction. The business has received cash of ₹10,000. It is its asset but on the other hand it has to pay a sum of ₹10,000 to *A,* the Proprietor.

Thus:

Capital and Liabilities	₹	*Assets*	₹
Capital	10,000	Cash	10,000

Transaction 2. *A* purchases furniture for cash worth ₹2,000. The position of his business will be as follows:

Capital and Liabilities	₹	Assets	₹
Capital	10,000	Cash	8,000
		Furniture	2,000
	10,000		10,000

Transaction 3. *A* purchases cotton bales from *B* for ₹5,000 on credit. He sells for cash cotton bales costing ₹3,000 for ₹4,000 and ₹1,000 for ₹1,500 on credit to *P.*

As a result of these transactions the business makes a profit of ₹1,500 (*i.e.* ₹5,500 –₹4,000) this will increase *A*'s Capital from ₹10,000 to ₹11,500. The business will have a liability of ₹5,000 to *B* and two more assets in the form of a debtor *P* for ₹1,500 and stock of cotton bales of ₹1,000. The position of his business will now be as follows:

Capital and Liabilities	₹	Assets	₹
Creditor (*B*)	5,000	Cash (₹8,000 + 4,000)	12,000
Capital	11,500	Stock of Cotton Bales	1,000
		Debtor (*P*)	1,500
		Furniture	2,000
	16,500		16,500

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Transaction 4. *A* withdraws cash of ₹1,000 and cotton bales of ₹200 for his personal use. The amount and the goods withdrawn will decrease relevant assets and *A*'s capital. The position will be now as follows:

Capital and Liabilities	₹	Assets	₹
Creditor (*B*)	5,000	Cash (₹12,000 – 1,000)	11,000
Capital (`11,500 – 1,200)	10,300	Stock of Cotton Bales	800
		Debtor (*P*)	1,500
		Furniture	2,000
	15,300		15,300

The above type of statement showing the financial position of a business on a certain date is termed as balance sheet.

The result of applying the system of double entry system may be summarised in the form of following rule:

"For every debit there must be equivalent credit and *vice versa*."

The rules of *Debit* and *Credit* have been explained in the succeeding chapter.

Illustration 1.1. Anil had the following transactions. Use accounting equation to show their effect on his assets, liabilities and capital:

		₹
1.	Started business with cash	5,000
2.	Purchased goods on credit	400
3.	Purchased goods for cash	100
4.	Purchased furniture	50
5.	Withdrew for personal use	70
6.	Paid rent	20
7.	Received Interest	10
8.	Sold goods costing ₹50 on credit for	70
9.	Paid to creditors	40
10.	Paid for salaries	20
11.	Further capital invested	1,000
12.	Borrowed from *P*	1,000

Solution:

Accounting Equation: Assets = Liabilities + Capital

No.	*Transaction*	*Assets*	=	*Liabilities*	+	*Capital*
		₹		₹		₹
1.	Anil started business with cash ₹5,000	5,000	=	0	+	5,000
2.	Purchased goods on credit for ₹400	400	=	400	+	0
	New Equation	5,400	=	400	+	5,000
3.	Purchase goods for cash ₹100	+ 100				
		– 100	=	0	+	0
	New Equation	5,400	=	400	+	5,000
4.	Purchased furniture ₹50	+ 50				
		– 50	=	0	+	0
	New Equation	5,400	=	400	+	5,000

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No.	Transaction	Assets	=	Liabilities	+	Capital
5.	Withdrew for personal use ₹70	– 70	=	0	–	70
	New Equation	5,330	=	400	+	4,930
6.	Paid rent	– 20	=	0	+	– 20
	New Equation	5,310	=	400	+	4,910
7.	Received interest ₹10	+ 10	=	0	+	10
	New Equation	5,320	=	400	+	4,920
8.	Sold goods consisting ₹50 on credit for ₹70	+ 70				
		– 50	=	0	+	20
	New Equation	5,340	=	400	+	4,940
9.	Paid to creditors ₹40	– 40	=	– 40	+	0
	New Equation	5,300	=	360	+	4,940
10.	Paid for salaries ₹20	– 20	=	0	–	– 20
	New Equation	5,280	=	360	+	4,920
11.	Further capital Invested	1,000	=	0	+	1,000
	New Equation	6,280	=	360	+	5,920
12.	Borrowed from *P* ₹1,000	1,000	=	1,000	+	0
	New Equation	7,280	=	1,360	+	5,920

1.3.2 Double Entry System and Single Entry System

The difference between the double entry system and single entry system can be put as follows:

(a) **Recording of transactions:** In case of double entry system, the dual aspect concept is completely followed while recording business transactions. In case of single entry system, the dual aspect concept is not followed for all transactions. In case of some transactions both the aspects are recorded, while for some only one aspect is recorded, while in case of some other transactions no recording is at all done.

(b) **Maintenance of books:** In case of double entry system, various subsidiary books viz., sales book, purchases book, returns book, cash book etc., are maintained. While in case of single entry system, no subsidiary books except cash book is maintained.

(c) **Maintenance of books of account:** In case of double entry system, all major accounts real, nominal and personal are maintained. However, in case of single entry system, only personal accounts are maintained.

(d) **Preparation of trial balance:** In case of double entry system, trial balance is prepared to check arithmetical accuracy of the books of account. While in case of single entry system trial balance cannot be prepared. Hence, it is not possible to check the accuracy of books of account.

(e) **Accuracy of profits and financial position:** In case of double entry system, Trading and Profit and Loss Account gives the true profit of the business while Balance Sheet shows the true and fair financial position of the business. While in case of single entry system only a rough estimate of profit or loss can be made. The Statement of Affairs prepared in single entry system also does not show the true financial position of the business.

(f) **Utility:** Single entry system is used only by very small business units. It has no utility for large business units. As a matter of fact, they have to compulsorily adopt double entry system.

1.3.3 Cash and Mercantile Systems of Accounting

There are basically two systems of accounting:

1. **Cash system of accounting** It is a system in which accounting entries are made only when cash is received or paid. No entry is made when a payment or receipts is merely due. Government system of accounting is mostly on the cash system. Certain professional people record their income on cash basis, but while recording expenses they take into account the outstanding expenses also. In such a case, the financial statement prepared by them for determination of their income is termed as Receipts and Expenditure Account.
2. **Mercantile or accrual system of accounting** It is a system in which accounting entries are made on the basis of amounts having become due for payment or receipt. This system recognises the fact that if a transaction or an event has occurred; its consequences cannot be avoided and, therefore, should be brought into books in order to present a meaningful picture of profit earned or loss suffered and also of the financial position of the firm concerned.

The difference between Cash System and Mercantile System of accounting will be clear with the help of the following example:

A firm closes its books on 31st December each year. A sum of ₹500 has become due for payment on account of rent for the year 2015. The amount has, however, been paid in January, 2016.

In this case, if the firm is following cash system of accounting, no entry will be made for the rent having become due in the books of accounts of the firm in 2015. The entry will be made only in January 2016 when the rent is actually paid. However, if the firm is following mercantile system of accounting, two entries will made: (*i*) on 31st December, 2015, rent account will be debited while the landlord's account will be credited by the amount of outstanding rent; (*ii*) In January, 2016 landlord's account will be debited while the cash account will be credited with the amount of the rent actually paid. (This has been discussed in detail later while dealing with adjustments relating to final accounts.)

The 'mercantile system' is considered to be better since it takes into account the effects of all transactions already entered into. This system is followed by most of the industrial and commercial firms.

1.4 ACCOUNTING CONCEPTS

The term 'concepts' includes those basic assumptions or conditions upon which the science of accounting is based. The following are the important accounting concepts:

(*i*) Separate Entity Concept
(*ii*) Going Concern Concept
(*iii*) Money Measurement Concept
(*iv*) Cost Concept
(*v*) Dual Aspect Concept
(*vi*) Accounting Period Concept
(*vii*) Periodic Matching of Cost and Revenue Concept
(*viii*) Realisation Concept

Let us study the different accounting concepts.

1. **Separate Entity Concept** In accounting business is considered to be a separate entity from the proprietor(s). It may appear to be ludicrous that one person can sell goods to himself but this concept is extremely helpful in keeping business affairs strictly free from the effect of private affairs of the proprietor(s). Thus, when one person invests ₹10,000 into business, it will be deemed that the proprietor has given that much of money to the business which will be shown as a 'liability' in the books of the business. In case the proprietor withdraws ₹2,000 from the business, it will be charged to him and the net amount payable by the business will be shown only as ₹8,000.

The concept of separate entity is applicable to all forms of business organisations. For example, in case of a partnership business or sole proprietorship business, though the partners or sole proprietor are not considered as separate entities in the eyes of law, but for accounting purposes they will be considered as separate entities.

2. **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.

It should be noted that 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 amortise 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 the 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.

3. **Money Measurement Concept** Accounting records only monetary transactions. Events or transactions which cannot be expressed in money do not find place in the books of accounts though they may be very useful for the business. For example, if a business has got a team of dedicated and trusted employees, it is definitely an asset to the business but since their monetary measurement is not possible, they are not shown in the books of the business.

Measurement of business event in money helps in understanding the state of affairs of the business in a much better way. For example, if a business owns ₹10,000 of cash, 600 kg of raw materials, two trucks, 1,000 square feet of building space etc., these amounts cannot be added together to produce a meaningful total of what the business owns. However, if these items are expressed in monetary terms such as ₹10,000 of cash, ₹12,000 of raw materials, ₹2,00,000 of trucks and ₹50,000 of building, all such items can be added and much more intelligible and precise estimate about the assets of the business will be available.

4. **Cost Concept** The concept is closely related to going concern concept. According to this concept:

(*a*) an asset is ordinarily entered in the accounting records at the price paid to acquire it, and

(*b*) this cost is the basis for all subsequent accounting for the assets.

If a business buys a plot of land for ₹50,000, the asset would be recorded in the books at ₹50,000 even if its market value at that time happens to be ₹60,000. In case a year later the market value of this assets comes down to ₹40,000, it will ordinarily continue to be shown at ₹50,000 and not at ₹40,000.

The cost concept does not mean that the asset will always be shown at cost. It has also been stated above that cost becomes the basis for all future accounting for the asset. It means that asset is recorded at cost at the time of its purchase, but it may systematically be reduced in its value by charging depreciation.

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Cost concept has the advantage of bringing objectivity in the preparation and presentation of financial statements. In the absence of this concept the figures shown in the accounting records would have depended on the subjective views of a person. However, on account of continued inflationary tendencies the preparation of financial statements on the basis of historical costs, has become largely irrelevant for judging the financial position of the business. This is the reason for the growing importance of inflation accounting.

5. **Dual Aspect Concept** This is the basic concept of accounting. According to this concept every business transaction has a dual effect. For example, if *A* starts a business with a capital of ₹10,000, there are two aspects of the transaction. On the one hand, the business has asset of ₹10,000 while on the other hand the business has to pay to the proprietor a sum of ₹10,000 which is taken as proprietor's capital. This expression can be shown in the form of following equation:

Capital (Equities) = Cash (Assets)

10,000 = 10,000

The term 'assets' denotes the resources owned by a business while the term "Equities" denotes the claims of various parties against the assets. As we have learned before, equities are of two types. They are: owners' equity and outsiders' equity. Owners' equity (or capital) is the claim of owners against the assets of the business while outsiders' equity (for liabilities) is the claim of outside parties, such as creditors, debenture-holders etc., against the assets of the business. Since all assets of the business are claimed by some one (either owners or outsiders), the total of assets will be equal to total of liabilities, Thus:

Equities = Assets

or Liabilities + Capital = Assets

In the example given above, if the business purchases furniture worth ₹5,000 out of the money provided by *A*, the situation will be as follows:

Equities = Assets

Capital ₹10,000 = Cash ₹5,000 + Furniture ₹5,000

Subsequently, if the business borrows ₹30,000 from a bank, the new position would be as follows:

Equities = Assets

Capital ₹10,000 + Bank Loan ₹30,000 = Cash ₹35,000 + Furniture ₹5,000

The term 'accounting equation' is also used to denote the relationship of equities to assets. The equation can be technically stated as "for each debit, there is an equivalent credit". As a matter of fact the entire system of double entry book-keeping is based on this concept.

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6. **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 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 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.

7. **Periodic Matching of Costs and Revenue 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 costs (expenses) of the period. The term matching, means appropriate association of related 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'. For example, if a salesman is paid commission in January, 2011, for sales made by him in December, 2010, the commission paid to the salesman in January, 2011 should be taken as the cost for sales made by him in December, 2010. This means that revenues of December, 2010 (*i.e.*, sales) should be matched with the costs incurred for earning that revenue (*i.e.*, salesman's commission) in December, 2010 (though paid in January, 2011). 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.

8. **Realisation Concept** According to this concept revenue is recognised when a sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. This can be well understood with the help of the following example:

A places an order with *B* for supply of certain goods yet to be manufactured. On receipt of order, *B* purchases raw materials, employs workers, produces the goods and delivers them to *A*. *A* makes payment on receipt of goods. In this case the sale will be presumed to have been made not at the time of receipt of the order for the goods but at the time when goods are delivered to *A*.

However, there are certain exceptions to this concept:

(*i*) In case of hire purchase the ownership of the goods passes to the buyer only when the last instalment is paid, but sales are presumed to have been made to the extent of instalments received and instalments outstanding (*i.e*. instalments due but not received).

(*ii*) In case of contracts accounts, though the contractor is liable to pay only when the whole contract is completed as per terms of the contract, the profit is calculated on the basis of work certified year after year as per certain accepted accounting norms.

Besides the aforementioned accounting concepts, there are two more concepts of accounting, which are discussed as follows:

Accrual concepts and Objectives

Accrual concept is the most fundamental principle of accounting which requires recording revenues when they are earned and not when they are received in cash, and recording expenses when they are incurred and not when they are paid. GAAP allows preparation of financial statements on accrual basis only (and not on cash basis). Application of accrual concept results in accurate reporting of net income, assets, liabilities and retained earnings which improves analysis of the company's financial performance and financial position over different periods.

Concept of Objective Evidence

According to this concept, no accounting record should be made unless it is supported by independently verifiable (i.e., objective) evidence. Generally, such evidence is in writing or should be reduced to writing before an accounting entry is made. All transactions must be evidenced by a document, e.g., cash sales are evidenced by cash memos, credit sales by invoices, payments through bank by check etc.

Check Your Progress

3. List the types of accounts which are maintained under double entry and single entry system.
4. What is contingent liability?

1.5 ACCOUNTING CONVENTIONS AND THEIR TYPES

The term 'conventions' includes those customs or traditions which guide the accountant while preparing the accounting statements. The following are the important accounting conventions.

(i) Convention of Conservatism (ii) Convention of Full Disclosure

(iii) Convention of Consistency (iv) Convention of Materiality

In this section, we will discuss the accounting conventions.

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1. **Conservatism** 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 the 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 the 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.

2. **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, 1956 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.[3] The practice of appending notes to the accounting statements (such as about contingent liabilities or market value of investments) is in pursuance to the convention of full disclosure.

3. **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 by followed year after year. Similarly, if depreciation is charged on fixed assets according

[3] American Institute of Certified Public Accountants, ''Inventuory of Generally Accepted Principles for Business Enterprises''.

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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.

4. **Materiality** 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 upto paise 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."

It should be noted that accounting is a man-made art designed to help man in achieving certain objectives. "The accounting principles, therefore, cannot be derived from or proven by laws of nature. They are rather in the category of conventions or rules developed by man from experience to fulfil the essential and useful needs and proposes in establishing reliable financial and operating information control for business entities. In this respect, they are similar to the principles of commercial and other social disciplines."[4]

Check Your Progress

5. Define going concern concept.
6. Why has the convention of conservatism become the target of criticism these days?

1.6 ACCOUNTING PRINCIPLES

Accounting practices follow certain guidelines. The rules that govern how accountants measure progress and communicate financial information fall under the heading "Generally Accepted Accounting Principles" (GAAP).

[4] American Institute of Certified Public Accountants, ''Inventuory of Generally Accepted Principles for Business Enterprises''.

GAAP comprises of conventions, rules and procedures that constitute accepted accounting practices at any given time. They are like the law or rules for conducting behaviour in a way acceptable to majority of the people. They may readily be defined as rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. They are a body of doctrines commonly associated with the theory and procedures of accounting, serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist.

It should be noted that GAAP differ from country to country because of the legislative requirements of each country, local accounting practices, customs, usage and business environment peculiar to each country. Each country has set up its own professional accounting body/regulatory authority to frame, implement and regulate the application of the GAAPs in the country. For example, in USA the Financial Accounting Standard Board (FASB) set up in 1973 makes major pronouncements called Statements of Financial Accounting Standards (SFAS) from time to time. Similarly, in UK the Accounting Standard Board set up in 1990 issues financial reporting standards. The Board has replaced the Accounting Standards Committee which was responsible for issuing Statements of Standard Account Practices (SSAPs) earlier from time to time. In India, the Accounting Standard Board set up by the Institute of Chartered Accountants of India issues the accounting standards to be observed by all business entities. However, the Ministry of Corporate Affairs (MCA) has also notified presently 40 Indian Accounting Standards (Ind AS), as a step towards convergence of International Financial Reporting Standards (IFRS) in India. It may be noted that Ind AS would be applicable to various classes of entities as may be prescribed by the relevant authorities such as Ministry of Corporate Affairs for the companies governed under the Companies Act, 2013 from the notified date(s). The existing Accounting Standards (AS) would continue to apply to entities other than those to which Ind AS would apply. In case of differences between the two standards i.e. AS issued by the Institute of Chartered Accountants of India and Ind AS notified by the Ministry of Corporate Affairs, Government of India, the Institute of Chartered Accountants of India would harmonise their differences. This, in some cases, has already been done e.g. withdrawal of AS 6: Depreciation Accounting and replacement of AS 10: Fixed Assets by AS 10: Property, Plant and *Equipment*.

1.7 ACCOUNTING STANDARDS

In the preceding section we have discussed the accounting principles. They are basically the rules that govern current accounting practices and are used as references to determine application of appropriate treatment of complex transactions. In order to ensure that the application of these rules/principles is uniform in different enterprises, and the financial statements are comparable, the accounting regulatory bodies in different countries have codified these principles/rules in the form of accounting standards. Thus, accounting standards are basically accounting principles which have been codified and formalised by concerned regulatory bodies.

In simple words, accounting standards are rules according to which accounting statements have to be prepared. They can be termed as statements of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements. Accounting Standards may vary from country to country or industry to industry depending upon specific requirements. According to Institute of Chartered Accountants of India "Accounting Standards act as pillars of financial reporting structure of the country as they lay down sound principles for recognition, measurement, presentation and disclosures of information in the financial statements, which substantially improve the quality of financial statements."

Objectives of Accounting Standards Financial statements provide useful financial information about an enterprise to various stakeholders to base their economic and financial decisions. The comparison of the financial statements of various reporting enterprises poses some difficulties because of the divergence in the methods and principles adopted by these enterprises in preparing their financial statements Accounting Standards have been evolved to bring uniformity to the extent possible in the accounting methods and principles adopted by the various enterprises.

Thus, accounting standards rationally harmonize the diverse accounting policies followed in the preparation and presentation of financial statements by different reporting enterprises so as to facilitate intra-firm and inter-firm comparison by the stakeholders to take informed economic decisions.

1.7.1 International Accounting Standards Committee and IAS/IFRS

History and Structure International Accounting Standards Committee (IASC) came into existence on 29th June, 1973 when 16 accounting bodies from nine nations (called founder-members)[5] signed the agreement and constitution for its formation. The Committee has its headquarters at London. Its interpretative arm was known as Standard Interpretation Committee (SIC).

The objective of the committee was "to formulate and publish in the public interest standards to be observed in the presentation of audited financial statements and to promote their world-wide acceptance and observance." The formulation of such standards will bring uniformity in terminology, approach and presentation of results. This will not only help in a correct understanding and exchange of economic and financial information but also in facilitating a smooth flow of international investment.

[5] The nine nations are: United States of America, Canada, United Kingdom and lreland, Australia, France, Germany, Japan, Mexico and the Netherlands.

Between 1973 and 2000, the *IASC* issued several Accounting Standards, known as International Accounting Standards (IASs) Since 2001, the *IASC* was renamed as the International Accounting Standard Board (IASB). The *IASB* has now taken over the work of *IASC*. Its members (currently 15 full time members) are responsible for the development and publication of *IFRSs* and approving interpretations as developed by *IFRIC*.

The *IASB* has issued a new series of pronouncements known as International Financial Reporting Standards (IFRSs) on topics on which there was no previous *IAS*. Besides this, the *IASB* has replaced some *lASs* with new *IFRSs*. Thus, now the *lASs* issued by the *IASC* and *IFRSs* issued by the *IASB* all come within the purview of *IASB*. An International Financial Reporting Interpretation Committee (IFRIC) has also been formed to provide interpretations of the standards similar to previous SIC.

The *IASB* works closely with stakeholders around the world, including investors, analysts, regulators, business leaders, accounting standard-setters and the accountancy profession.

Objectives of IASB The broad objectives of *IASB* as per the IFRS Foundation, (not for profit private sector organisation) can be summarised as under.

(*a*) To develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information to make economic decisions;

(*b*) To promote the use and rigorous application of those standards;

(*c*) To pay attention to the needs of medium and small scale enterprises and emerging economies in tunc with (*a*) and (*b*) objectives stated above; and

(*d*) To promote and facilitate adoption of IFRSs, being the standards and interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs.

Meaning of IFRS It is a set of international accounting standards developed by the International Accounting Standards Board (IASB) providing the mode of reporting particular type of transactions and events in the financial statements. They include standards and interpretations issued by the International Accounting Standards Board (IASB) and its predecessor body, viz., International Accounting Standards Committee (IASC). They comprise:

(*a*) International Financial Reporting Standards;

(*b*) International Accounting Standards, and (*c*) Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

Objective of IFRS The basic objective of IFRSs is to make international comparison of financial statements of business enterprises as easy as possible. At present it is difficult since each country has its own set of rules. IFRSs have been designed as a common global language for business affairs to synchronize accounting standards across the globe. They are progressively replacing the many different national accounting standards. They require the accountants to maintain books of account in a manner that the financial statements based on them are comparable, understandable, reliable and relevant as per the requirements of users—both internal and external.

Scope of IFRS The scope of IFRS is as under.

(*i*) IFRS apply to the general purpose financial statements and other financial reporting by profit-oriented entities— those engaged in commercial, industrial, financial, and similar activities, regardless of their legal form.

Explanations:

(*a*) General purpose financial statements are intended to meet the common needs of shareholders, creditors, employees, and the public at large for information about an entity's financial position, performance, and cash flows.

(*b*) Other financial reporting includes information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions.

(*ii*) Entities other than profit-oriented business entities may also find IFRSs appropriate.

(*iii*) IFRSs apply to individual company and consolidated financial statements.

IFRS Assumptions There are four underlying assumptions in IFRS as detailed below.

1. **Accrual basis:** The assumption that the financial effect of transactions and events are recognised as they occur, not when cash is received or paid.
2. **Going concern:** The assumption that a business entity will be in operation for the foreseeable future.
3. **Measuring unit:** Measuring unit for valuation of capital is the current purchasing power. In other words assets should be reflected in the financial statements at their fair value.

4. **Unit of constant purchasing power:** The value of capital should be adjusted at end of the financial year to inflation prevailing in the economy.

IFRS Around the World

IFRS is a globally accepted financial reporting framework. It is used over 110 countries but in both the US and the UK, the Generally Accepted Accounting Principles (GAAP) is the more widely used set of guidelines for accountants.

Currently the Financial Accounting Standards Board (FASB) of USA and the IASB are working on numerous joint projects designed to improve the GAAP and the IFRS with the goal to ultimately make the standards fully compatible.

In India also we are following GAAP *i.e.*, accounting standards as prescribed by Institute of Chartered Accountants of India. Of course steps are being taken for converging the Indian Accounting Standards with IFRS, as discussed later in the unit.

IFRS Main Financial Statements

Types : The IFRS financial statements include the following.

- A Statement of Financial Position. It comprises Assets, Liabilities and Equity
- A Statement of Comprehensive Income. It includes two separate statements (*i*) an Income Statement and (*ii*) a Statement of Comprehensive Income. The Statement of Comprehensive Income reconciles the Profit or Loss as per Income Statement to total comprehensive income
- A Statement of Changes in Equity
- A Cash Flow Statement or Statement of Cash Flows
- Notes, comprising a summary of the significant accounting policies

Objective: A financial statement should present true and fair picture of the business affairs of an organisation. Since these statements are used by different constituents of the regulators/society, they are required to present the true view of financial position of the organisation.

Qualitative characteristics: As per IFRS, the main characteristics required in its main financial statement include:

- Understandability
- Relevance
- Reliability
- Comparability

Current Status of IAS/IFRS and Interpretations The current status of International Accounting Standards (IAS), International Financial Reporting Standards (IFRS), and Interpretations issued by Standing Interpretation Committee (SIC), International Financial Reporting Interpretation Committee (IFRIC) is as under.

International Accounting Standards (IASs) All 41 IASs have been issued out of which 12 have been withdrawn. Thus, at present 29 IAS are in operation. They are as under.

IAS 1. Presentation of Financial Statements.

IAS 2. Inventories.

IAS 7. Cash Flow Statements.

IAS 8. Accounting Policies, Changes in Accounting Estimates and Errors.

IAS 10. Events after the Balance Sheet Date.

IAS 11. Construction Contracts.

IAS 12. Income Taxes.

IAS 16. Property, Plant and Equipment.

IAS 17. Leases.

IAS 18. Revenue.

IAS 19. Employee Benefits.

IAS 20. Accounting for Government Grants and Disclosure of Government Assistance.

IAS 21. The Effects of Changes in Foreign Exchange Rates.

IAS 23. Borrowing Costs

IAS 24. Related Party Disclosures.

IAS 26. Accounting and Reporting by Retirement Benefit Plans.

IAS 27. Consolidated and Separate Financial Statements.

IAS 28. Investments in Associates.

IAS 29. Financial Reporting in Hyperinflationary Economies.

IAS 31. Interests in Joint Ventures.

IAS 32. Financial Instruments: Presentation

IAS 33. Earnings per share.

IAS 34. Interim Financial Reporting.

IAS 36. Impairment of Assets.

IAS 37. Provisions, Contingent Liabilities and Contingent Assets.

IAS 38. Intangible Assets.

IAS 39. Financial Instruments: Recognition and Measurement.

IAS 40. Investment Property.

IAS 41. Agriculture.

NOTES

International Financial Reporting Standards (IFRSs) In all 15 IFRSs have been issued out of which one is under reconsideration. The list is as under.

No.	*Title*	*Originally issued*	*Effective*
IFRS I	First-time Adoption of International Financial Reporting Standard	2003	Jan. 1, 2004
IFRS 2	Share-based Payment	2004	Jan. 1, 2005
IFRS 3	Business Combinations	2004	Apr. l, 2004
IFRS 4	Insurance Contracts	2004	Jan. 1, 2005
IFRS 5	Non-current Assets held for Sale and Discontinued Operations	2004	Jan. 1,2005
IFRS 6	Exploration for and Evaluation of Mineral Resources	2004	Jan. 1, 2006
IFRS 7	Financial instrument: Disclosures	2005	Jan. 1, 2007
IFRS 8	Operating Segments	2006	Jan. 1, 2009
IFRS 9	Financial instruments	2009 (updated 2014)	Jan. 1, 2018
IFRS 10	Consolidated Financial Statements	2011	Jan. 1, 2013
IFRS 11	Joint Arrangements	2011	Jan. 1, 2013
IFRS 12	Disclosure of Interests in Other Entities	2011	Jan. 1, 2013
IFRS 13	For Value Measurement	2011	Jan. 1, 2013
IFRS 14	Regulatory Deferral Accounts	2014	Jan. 1, 2016
IFRS 15	Revenue from Contracts with Customers	2014	Jan. 1, 2017

Interpretations Issued by SIC/IFRIC In all 26 interpretations have been issued as given under.

SIC 7 Introduction of the Euro

SIC 10 Government Assistance - No Specific Relation to Operating Activities

SIC 12 Consolidation - Special-Purpose Entities

SIC 13 Jointly Controlled Entities - Non-monetary Contributions by Ventures

SIC 15 Operating Leases - Incentives

SIC 21 Income Taxes - Recovery of Revalued Non-Depreciable Assets

SIC 25 Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders.

SIC 27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease

SIC 29 Service Concession Arrangements: Disclosures

SIC 31	Revenue - Barter Transactions lnvolving Advertising Services
SIC 32	Intangible Assets - Web Site Costs
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFR1C 2	Members' Shares in Co-operative Entities and Similar Liabilities
IFRIC 4	Determining Whether an Arrangement contains a Lease
IFRIC 5	Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds.
IFRIC 6	Liabililies arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS 29, Financial Reporting in Hyperinflationary Economies
IFRIC 8	Scopc of IFRS 2
IFRIC 9	Reassessment of Embedded Derivatives
IFRIC 10	Interim Financial Reporting and Impairment
IFRIC 11	IFRS 2: Group and Treasury Share Transactions
IFRIC 12	Service Concession Arrangements
IFRIC 13	Customer Loyalty Programmes
IFRIC 14	IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements, and their Interaction
IFRIC 15	Agreements for the Construction of Real Estate
IFRIC 16	Hedges of a Net Investment in a Foreign Operation

Check Your Progress

7. What is GAAP?
8. State the objective of IFRS.
9. Which International Accounting Standard deals with employee benefits?

1.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Some of the users of accounting information are proprietors, managers, creditors, prospective investors, government, employees and citizen.
2. The Balance Sheet or the Position Statement of a business is the accounting tool which helps to ascertain the financial position of a business.

3. In case of double entry system, all major accounts real, nominal and personal are maintained. However, in case of single entry system, only personal accounts are maintained.
4. Contingent liability is an obligation relating to existing condition or situation which may arise in future depending upon the occurrence or non-occurrence of one or more uncertain future events.
5. According to the going concern 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.
6. The convention of conservatism become the target of criticism these days because it goes against the convention of full disclosure. It encourages the accountant to create separate reserves and the financial statements do not depict a true and fair view of the state of affairs of the business.
7. GAAP or Generally Accepted Accounting Principles are a set of conventions, rules and procedures that constitute accepted accounting principles at any given time.
8. The basic objective of IFRSs is to make international comparison of financial statements of business enterprises as easy as possible.
9. The International Accounting Standard 19 or IAS 19 deals with employee benefits.

1.9 SUMMARY

- Earlier, accounting was considered simply as a process of recording business transactions and the role of accountant as that of record-keeper. However, accounting is now considered to be a tool of management providing vital information concerning the organisation's future. Accounting today is thus more of an information system rather than a mere recording system.
- Some people take book-keeping and accounting as synonymous terms, but they are different from each other. Book-keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner.
- Accounting is primarily concerned with designing the systems for recording, classifying and summarizing the recorded data and interpreting them for internal and external end users. Accountants often direct and review the work of the book-keepers.
- Accounting is of primary importance to the proprietors and the managers. However, other persons such as creditors, prospective

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investors, employees, etc., are also interested in the accounting information.

- The objectives of accounting are: to keep systematic records, to protect business properties, to ascertain the financial position of business, to facilitate rational decision making, etc.
- Limitations of accounting are: provides only limited information, provides only a post-mortem record of business transactions, considers only quantifiable information, etc.
- An incomplete double entry system can be termed as a single entry system. According to Kohler, "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". This system has been developed by some business houses, who for their convenience, keep only some essential records.
- The system of 'double entry' book-keeping which is believed to have originated with the Venetian merchants of the fifteenth century, is the only system of recording the two-fold aspect of the transaction.
- Cash system of accounting is a system in which accounting entries are made only when cash is received or paid. Mercantile or accrual system of accounting is a system in which accounting entries are made on the basis of amounts having become due for payment or receipt.
- Accounting principles may be defined as those rules of action adopted by the accountants universally while recording accounting transaction.
- The term 'concepts' includes those basic assumptions or conditions upon which the science of accounting is based. The following are the important accounting concepts: (i) Separate Entity Concept, (ii) Going Concern Concept, (iii) Money Measurement Concept, (iv) Cost Concept, (v) Dual Aspect Concept and (vi) Accounting Period Concept.
- The term 'conventions' includes those customs or traditions which guide the accountant while preparing the accounting statements. The following are the important accounting conventions. (i) Convention of Conservatism, (ii) Convention of Full Disclosure, (iii) Convention of Consistency and (iv) Convention of Materiality.
- There are several accounting concepts like: separate entity concept, going concern concept, money measurement concept, cost concept, dual aspect concept, accounting period concept, periodic matching of costs and revenue concept, and realization concept.
- Accounting practices follow certain guidelines. The rules that govern how accountants measure progress and communicate financial information fall under the heading "Generally Accepted Accounting

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Principles" (GAAP). GAAP comprises of conventions, rules and procedures that constitute accepted accounting practices at any given time.

- Accounting standards are basically accounting principles which have been codified and formalised by concerned regulatory bodies.
- Accounting standards rationally harmonize the diverse accounting policies followed in the preparation and presentation of financial statements by different reporting enterprises so as to facilitate intra-firm and inter-firm comparison by the stakeholders to take informed economic decisions.
- International Accounting Standards Committee (IASC) came into existence on 29th June, 1973 when 16 accounting bodies from nine nations (called founder-members) signed the agreement and constitution for its formation. The Committee has its headquarters at London. Its interpretative arm was known as Standard Interpretation Committee (SIC).
- Between 1973 and 2000, the IASC issued several Accounting Standards, known as International Accounting Standards (IASs) Since 2001, the IASC was renamed as the International Accounting Standard Board (IASB). The IASB has now taken over the work of IASC.
- The IASB has issued a new series of pronouncements known as International Financial Reporting Standards (IFRSs) on topics on which there was no previous IAS. Besides this, the IASB has replaced some lASs with new IFRSs. Thus, now the lASs issued by the IASC and IFRSs issued by the IASB all come within the purview of IASB.
- All 41 IASs have been issued out of which 12 have been withdrawn. Thus, at present 29 IAS are in operation. In all 15 IFRSs have been issued out of which one is under reconsideration.

1.10 KEY WORDS

- **Accounting**: The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of information.
- **Financial Accounting**: The art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are at least in part of a financial character and interpreting the results.
- **Asset:** A tangible object or an intangible right owned by an enterprise and carrying probable future benefits.
- **Capital:** Owners' equity in the business.

- **Capital Expenditure:** An expenditure incurred for the purpose of obtaining a long-term advantages for the business.
- **Goods:** The property in which the business deals.
- **Liability:** An amount which business owes and has to return or account for.
- **Revenue:** An income of a recurring nature from any source.
- **Revenue Expenditure:** An expenditure whose benefit expires within a year or which is incurred merely to maintain the business or keeping the assets in good working condition.
- **Accounting Concepts:** Basic assumptions or conditions upon which the science of accounting is based.
- **Accounting Conventions:** Customs and traditions which guide the accountants while preparing the accounting statements.
- **Accounting Principles:** Rules of action or conduct adopted by the accountants universally while recording accounting transactions.
- **Cash System of Accounting:** A system in which accounting entries are made only when cash is received or paid.
- **Mercantile System of Accounting:** A system in which accounting entries are made on the basis of amounts having become due for payment or receipt. It is also termed as Accrual System of Accounting.

1.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Define Accounting. State its functions. How does it differ from Book-keeping?
2. State the persons who should be interested in accounting information.
3. Define the term Convention of Conservations.
4. Define the term Convention of Materiality.
5. Define the term Convention of Disclosure.

Long Answer Questions

1. Discuss briefly the basic accounting concepts and fundamental accounting assumptions.
2. What are the accounting concepts and conventions? Name them and explain any two accounting concepts in detail.

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3. Explain any three of the following accounting concepts:
   (i) Money measurement concept (ii) Business entity concept
   (iii) Going concern concept (iv) Realisation concept
   (v) Cost concept.
4. What is meant by the term, 'Generally Accepted Accounting Principles'? Explain the meaning and significance of any two of the following:
   (i) The Going concern principle (ii) Convention of consistency
   (iii) Matching principle (iv) Substance over form

1.12 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

Jain, S.P. and Narang, K.L. 2001. *Advanced Accountancy*. New Delhi: Kalyani Publishers.

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UNIT 2 FUNDAMENTALS OF BOOK-KEEPING

NOTES

Structure

2.0 INTRODUCTION

In this unit, you will learn about the classification of accounts and recording of transactions. It has been explained in Unit 1 that Accounting is the art of recording, classifying and summarising the financial transactions and interpreting the results therefore. Thus, accounting cycle involves the following stages:

1. **Recording of transactions** This is done in the book termed as 'Journal'.
2. **Classifying the transactions** This is done in the book termed as 'Ledger'.
3. **Summarising the transactions** This includes preparation of the trial balance, profit and loss account and balance sheet of the business.
4. **Interpreting the results** This involves computation of various accounting ratios, etc., to know about the liquidity, solvency and profitability of business. The recording of transactions in the Journal is being explained in this unit.

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2.1 OBJECTIVES

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

- Identify the stages of the accounting cycle
- Appreciate the role of Journal in recording business transactions
- Understand the rules of debit and credit applicable to different types of business transactions
- Describe the various sub-divisions of journal
- Discuss the methods of preparation of a trial balance

2.2 JOURNAL

The Journal records all daily transactions of a business into the order in which they occur. A Journal may, therefore, be defined as a book containing a chronological record of transactions. It is the book in which the transactions are recorded first of all under the double entry system. Thus, Journal is the book of original record. A Journal does not replace but precedes the Ledger. The process of recording transaction in a Journal, is termed as Journalising. A proforma of journal is given as:

JOURNAL

Date	*Particulars*	*L.F.*	*Debit* ₹	*Credit* ₹
(1)	(2)	(3)	(4)	(5)

1. **Date** The date on which the transaction was entered is recorded here.
2. **Particulars** The two aspects of transaction are recorded in this column, *i.e.*, the details regarding accounts which have to be debited and credited.
3. **L.F.** It means Ledger Folio. The transactions entered in the Journal are later on posted to the ledger. The relevant ledger folio is entered here. Procedure regarding posting the transactions in the Ledger has been explained in the next unit.
4. **Debit** In this column, the amount to be debited is entered.
5. **Credit** In this column, the amount to be credited is shown.

2.2.1 Rules of Debit and Credit

The transactions in the Journal are recorded on the basis of the rules of debit and credit. For this purpose business transactions have been classified into three categories:

(*i*) Transactions relating to persons.

(*ii*) Transactions relating to properties and assets.

(*iii*) Transactions relating to incomes and expenses.

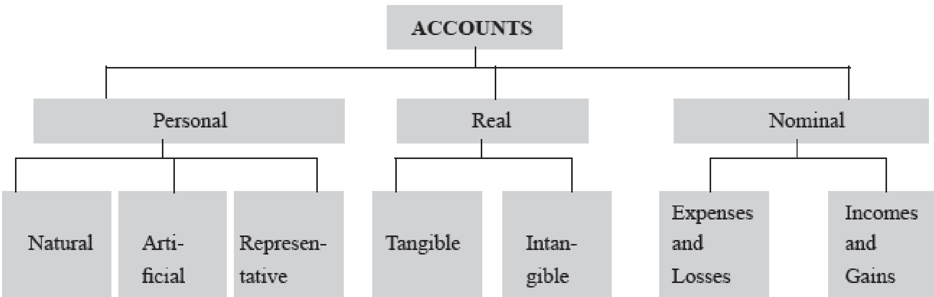
On this basis, it becomes necessary for the business to keep an account of:

(*i*) Each person with whom it deals.

(*ii*) Each property or asset which the business owns.

(*iii*) Each item of income or expense.

The accounts falling under the first heading are called as 'Personal Accounts'. The accounts falling under the second heading are termed as 'Real Accounts'. The accounts falling under the third heading are termed as 'Nominal Accounts'. The classification of the accounts, as explained above, can be put in the form of the following chart:



Each of the above categories of accounts and the relevant rule for 'debit and credit' have been explained in detail in the following pages:

Personal accounts Personal accounts include the accounts of persons with whom the business deals. These accounts can be classified into the three categories.

1. *Natural Personal Accounts* The term 'Natural Persons' means persons who are creation of God. For example, Mohan's Account, Sohan's Account, Abha's Account etc.

2. *Artificial Personal Accounts* These accounts include accounts of corporate bodies or institutions which are recognised as persons in business dealings. For example, the account of a Limited Company, the account of a Co-operative Society, the account of a Club, the account of Government, the account of an Insurance Company etc.

3. *Representative Personal Accounts* These are accounts which represent a certain person or group of persons. For example, if the rent is due to the landlord, an outstanding rent account will be opened in the books. Similarly, for salaries due to the employees (not paid), an outstanding salaries account will be opened. The outstanding rent account represents the account of the landlord to whom the rent is to be paid while the outstanding salaries

account represents the accounts of the persons to whom the salaries have to be paid. All such accounts are, therefore, termed as 'Representative Personal Accounts'.

The rule is:

- Debit the Receiver
- Credit the Giver

For example, if cash has been paid to Ram, the account of Ram will have to be debited. Similarly, if cash has been received from Keshav, the account of Keshav will have to be credited.

Real accounts Real accounts may be of the following types:

1. *Tangible real accounts* Tangible Real Accounts are those which relate to such things which can be touched, felt, measured etc. Examples of such accounts are cash account, building account, furniture account, stock account, etc. It should be noted that bank account is a personal account; since it represents the account of the banking company—an artificial person.
2. *Intangible real accounts* These accounts represent such things which cannot be touched. Of course, they can be measured in terms of money. For example, patents account, goodwill account, etc.

   The rule is:

   - Debit What Comes In
   - Credit What Goes Out

For example, if building has been purchased for cash, building account should be debited (since it is coming into the business) while cash account should be credited (since cash is going out of the business). Similarly when furniture in purchased for cash, furniture account should be debited while the cash account should be credited.

Nominal accounts These accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. For example, in a business, salary is paid to the manager, rent is paid to the landlord, commission is paid to the salesman—cash goes out of the business and it is something real; while salary, rent or commission as such do not exist. The accounts of these items are opened simply to explain how the cash has been spent. In the absence of such information, it may be difficult for the person concerned to explain how the cash at his disposal was utilised.

Nominal Accounts include accounts of all expenses, losses, incomes and gains. The examples of such accounts are rent, rates lighting, insurance, dividends, loss by fire, etc.

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The rule is:

- Debit All Expenses And Losses
- Credit All Gains And Incomes

Tutorial Note. Both Real Accounts and Nominal Accounts come in the category of Impersonal Accounts. The student should note that when some prefix or suffix is added to a Nominal Account, it becomes a Personal Account. A table is being given to explain the above rule:

Nominal Account	*Personal Account*
1. Rent account	Rent prepaid account, Outstanding rent account.
2. Interest account	Outstanding interest account, Interest received in advance account, Prepaid interest account.
3. Salary account	Outstanding salaries account, Prepaid salaries account.
4. Insurance account	Outstanding insurance account, Prepaid insurance account.
5. Commission account	Outstanding commission account, Prepaid commission account.

Illustration 2.1. From the following transactions find out the nature of account and also state which account should be debited and which account should be credited.

(*a*) Rent paid.
(*b*) Salaries paid.
(*c*) Interest received.
(*d*) Dividends received.
(*e*) Furniture purchased for cash.
(*f*) Machinery sold.
(*g*) Outstanding for salaries.
(*h*) Telephone charges paid.
(*i*) Paid to Suresh.
(*j*) Received from Mohan (the proprietor).
(*k*) Lighting.

Solution:

	Transaction	*Accounts involved*	*Nature of Accounts*	*Debit/Credit*
(*a*)	Rent paid	Rent A/c	Nominal A/c	Debit
		Cash A/c	Real A/c	Credit
(*b*)	Salaries paid	Salaries A/c	Nominal A/c	Debit
		Cash A/c	Real A/c	Credit
(*c*)	Interest received	Cash A/c	Real A/c	Debit
		Interest A/c	Nominal A/c	Credit
(*d*)	Dividends received	Cash A/c	Real A/c	Debit
		Interest A/c	Nominal A/c	Credit
(*e*)	Furniture purchased	Furniture A/c	Real A/c	Debit
		Cash A/c	Real A/c	Credit
(*f*)	Machinery sold	Cash A/c	Real A/c	Debit
		Interest A/c	Real A/c	Credit
(*g*)	Outstanding for salaries	Salaries A/c	Nominal A/c	Debit
		Outstanding Salaries A/c	Personal A/c	Credit
(*h*)	Telephone charges paid	Telephone Charges A/c	Nominal A/c	Debit
		Cash A/c	Real A/c	Credit
(*i*)	Paid to Suresh	Suresh	Personal A/c	Debit
		Cash A/c	Real A/c	Credit

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(*j*)	Received from Mohan (the proprietor)	Cash A/c	Real A/c	Debit
		Capital A/c	Personal A/c	Credit
(*k*)	Lighting	Lighting A/c	Nominal A/c	Debit
		Cash A/c	Real A/c	Credit

The journalising of the various transactions is explained now with the help of the following illustration:

Illustration 2.2. Ram starts a business with capital of ₹20,000 on January 1, 2011.

In this case there are two accounts involved. They are:

(*i*) The account of Ram. (*ii*) Cash Account.

Solution: 1. Ram is natural person and, therefore, his account is a Personal Account. Cash Account is a tangible asset and, therefore, it is a Real Account. As per the rules of Debit and Credit, applicable to Personal Accounts, Ram is the giver and, therefore, his account, *i.e.*, Capital Account should be credited. Cash is coming in the business and, therefore, as per the rules applicable to Real Accounts, it should be debited. The transaction will now be entered in the Journal as follows:

JOURNAL

Date	*Particulars*	*L.F.*	*Debit* ₹	*Credit* ₹
2011				
Jan. 1	Cash Account Dr.		20,000	
	To Capital Account			20,000
	(Being commencement of business)			

The words put within brackets "Being commencement of business" constitute the narration for the entry passed, since, they narrate the transaction.

2. He purchased furniture for cash for ₹5,000 on January 5, 2011.

The two accounts involved in this transaction are the Furniture Account and the Cash Account. Both are Real Accounts. Furniture is coming in and, therefore, it should be debited while cash is going out and, therefore, it should be credited. The Journal entry will, therefore, be as follows:

JOURNAL

Date	*Particulars*	*L.F.*	₹	₹
2011				
Jan. 5	Furniture Account Dr.		5,000	
	To Cash Account			5,000
	(Being purchase of furniture)			

3. He paid rent for business premises ₹2,000 on January 10, 2011.

In this transaction, two accounts involved are the Rent Account and the Cash Account. Rent Account is Nominal Account. It is an expense and, therefore, it should be debited. Cash Account is a Real Account. It is going

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out of the business and, therefore, it should be credited. The journal entry will, therefore, be as follows:

JOURNAL

Date	*Particulars*	*L.F.*	₹	₹
2011				
Jan. 10	Rent Account Dr.		2,000	
	To Cash Account			2,000
	(Being payment of rent)			

4. He purchased goods on credit of ₹2,000 from Suresh on January 20, 2011.

The two accounts involved in the transaction are those of Suresh and Goods. The account of Suresh is a Personal Account while that of Goods is a Real Account. Suresh is the giver of goods and, therefore, his account should be credited while Goods are coming in the business and, therefore, Goods Account should be debited.

JOURNAL

Date	*Particulars*	*L.F.*	₹	₹
2011				
Jan. 20	Goods Account Dr.		2,000	
	To Suresh			2,000
	(Being purchase of goods on credit)			

Classification of Goods Account 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 Purchases Account is debited on purchase of goods.

(*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.

(*iii*) *Purchases Returns 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.

(*iv*) *Sales Returns Account* The account is meant for recording return of goods sold, by the customers. The goods "come in" and, therefore, the Sales Returns Account should be debited on return of goods.

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The above classification of Goods Account can be shown in the form of the following chart:

GOODS ACCOUNT

Purchases A/c Goods come in (*Dr.*)	*Sales A/c* Goods go out (*Cr.*)	*Purchases Returns A/c* Goods go out (*Cr.*)	*Sales Returns A/c* Goods come in (*Dr.*)

2.2.2 Compound Journal Entry

Sometimes there are a number of transactions on the same date relating to one particular account or of one particular nature. Such transactions may be recorded by means of a single journal entry instead of passing several journal entries. Such entry regarding recording a number of transactions is termed as a "Compound Journal Entry". It may be recorded in any of the following three ways:

(*i*) One particular account may be debited while several other accounts may be credited.

(*ii*) One particular account may be credited while several other accounts may be debited.

(*iii*) Several accounts may be debited and several other accounts may also be credited.

This has been explained in the following illustration:

Illustration 2.3. Pass a compound journal entry in each of the following cases:

1. Payment made to Ram ₹1,000. He allowed a cash discount of ₹50.
2. Cash received from Suresh ₹800 and allowed him ₹50 as discount.
3. A running business was purchased by Mohan with the following assets and liabilities:

   Cash ₹2,000; Land ₹4,000; Furniture ₹1,000; Stock ₹2,000; Creditors ₹1,000; Bank Overdraft ₹2,000.

Solution:

JOURNAL

Sl. No.	*Particulars*		*L.F.*	*Debit* ₹	*Credit* ₹
1.	Ram	Dr.		1,050	
	To Cash A/c				1,000
	To Discount A/c				50
	(Being payment made to Ram ₹1,000, and he allowed ₹50 as discount)				
2.	Cash A/c	Dr.		800	
	Discount A/c	Dr.		50	
	To Suresh				850

Sl. No.	Particulars		L.F.	Debit ₹	Credit ₹
	(Being cash received from Suresh ₹800 and discount allowed ₹50)				
3.	Cash A/c	Dr.		2,000	
	Land A/c	Dr.		4,000	
	Furniture A/c	Dr.		1,000	
	Stock A/c	Dr.		2,000	
	To Creditors				1,000
	To Bank Overdraft				2,000
	To Capital A/c				6,000
	(Being commencement of business by Mohan by taking over a running business)				

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Notes:

1. The total of payment due to Ram was ₹1,050. A payment of ₹1,000 has been made to him and he allowed a discount of ₹50. This means by paying ₹1,000, a full credit for ₹1,050 has been obtained. The account of Ram is a Personal Account, and therefore, it has been debited as he is the receiver. The cash has gone out of the business and, therefore, Cash Account being a Real Account, has been credited. Discount Account is a Nominal Account; getting discount is a gain to the business and, therefore, it has been credited.
2. Suresh was to pay sum of ₹850. He paid ₹800 and he was allowed a discount of ₹50. It means by paying ₹800 only, Suresh could get a full credit of ₹850. The Cash Account is a Real Account and, therefore, it has been debited since cash is coming in. Discount Account is a Nominal Account; it has been debited since it is a loss to the business. Suresh is the giver. His account being a Personal Account, it has been credited by ₹850.
3. It is not necessary that a person should start business only with cash. He may bring the assets into the business or he may purchase a running business. Mohan in the present case has purchased the assets of some other business. The net assets (*i.e.* assets–liabilities taken over) will be the capital of Mohan. The business is getting various assets and, therefore, the assets accounts have been debited. The business creates certain liabilities in the form of creditors, bank overdraft, and, therefore, these accounts have been credited. Mohan's Account, *i.e.,* his Capital Account has been credited by the balance since it represents the capital brought in by him.

2.2.3 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 Assets Accounts are debited while all Liabilities 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 the following illustration:

Illustration 2.4. Pass the Opening Entry on January 1, 2016 on the basis of the following information taken from the business of Mr. Sunil:

		₹
(*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

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Solution:

JOURNAL

Date	*Particulars*		*L.F.*	₹	₹
2016	Cash A/c	Dr.		2,000	
Jan.1	Sundry Debtors A/c	Dr.		6,000	
	Stock A/c	Dr.		4,000	
	Plant A/c	Dr.		5,000	
	Land & Buildings A/c	Dr.		10,000	
	To Sundry Creditors				10,000
	To Capital A/c (balancing figure)				17,000
	(Being balances brought forward from the last year)				
				27,000	27,000

Debit Balances on Jan. 1, 2016:

1. Jan. 01 Cash in hand ₹8,000

Cash at Bank ₹25,000

Stock of Goods ₹20,000

Furniture ₹2,000

Building ₹10,000

Sundry Debtors:

Vijay ₹2,000

Anil ₹1,000

Madhu ₹2,000

Credit Balances on Jan. 1, 2016:

Sundry Creditors

Anand ₹5,000

Loan from Bablu ₹10,000

Following were further transactions in the month of January, 2016:

2. Jan. 01 Purchased goods worth ₹5,000 for cash *less* 20% trade discount and 5% cash discount.
3. Jan. 04 Received ₹1,980 from Vijay and allowed him ₹20 as discount.
4. Jan. 06 Purchased goods from Bharat ₹5,000.
5. Jan. 08 Purchased plant from Mukesh for ₹5,000 and paid ₹100 as cartage for bringing the plant to

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			the factory and another ₹200 as installation charges.
6.	Jan.	12	Sold goods to Rahim on credit ₹600.
7.	Jan.	15	Rahim became an insolvent and could pay only 50 paise in a rupee.
8.	Jan.	18	Sold goods to Ram for cash ₹1,000.
9.	Jan.	20	Paid salary to Ratan ₹2,000.
10.	Jan.	21	Paid Anand ₹4,800 in full settlement.
11.	Jan.	26	Interest received from Madhu ₹200.
12.	Jan.	28	Paid to Bablu interest on loan ₹500.
13.	Jan.	31	Sold Goods for cash ₹500.
14.	Jan.	31	Withdrew goods from business for personal use ₹200.

Solution:

JOURNAL

Sl. No.	Date	Particulars		L.F.	Debit ₹	Credit ₹
1.	2016					
	Jan. 1	Cash A/c	Dr.		8,000	
		Bank A/c	Dr.		25,000	
		Stock A/c	Dr.		20,000	
		Furniture A/c	Dr.		2,000	
		Building A/c	Dr.		10,000	
		Vijay	Dr.		2,000	
		Anil	Dr.		1,000	
		Madhu	Dr.		2,000	
		To Anand				5,000
		To Bablu's Loan A/c				10,000
		To Capital A/c				55,000
		(Being balances brought forward from last year)				
2.	Jan. 1	Purchases A/c	Dr.		4,000	
		To Cash A/c				3,800
		To Discount A/c				200
		(Being purchase of goods for cash worth ₹5,000 allowed 20% trade discount and 5% cash discount on ₹4,000)				
3.	Jan. 4	Cash A/c	Dr.		1,980	
		Discount A/c	Dr.		20	
		To Vijay				2,000
		(Being cash received from Vijay, allowed ₹20 as cash discount)				
4.	Jan. 4	Purchases A/c	Dr.		5,000	
		To Bharat				5,000
		(Being purchases of goods from Bharat)				
5.	Jan. 8	Plant A/c	Dr.		5,300	

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Sl. No.	Date	Particulars		L.F.	Debit ₹	Credit ₹
		To Mukesh				5,000
		To Cash				300
		(Being purchase of plant for ₹5,000 and payment of ₹100 as cartage and ₹200 as installation charges)				
6.	Jan. 12	Rahim	Dr.		600	
		To Sales A/c				600
		(Being sale of goods to Rahim)				
7.	Jan. 15	Cash A/c	Dr.		300	
		Bad Debts A/c	Dr.		300	
		To Rahim				600
		(Being cash received from Rahim after his being declared as an insolvent. 50% of the amount due has been received and the rest has been taken as a bad debt)				
8.	Jan. 18	Cash A/c	Dr.		1,000	
		To Sales A/c				1,000
		(Being cash sales)				
9.	Jan. 20	Salary A/c	Dr.		2,000	
		To Cash				2,000
		(Being salary paid)				
10.	Jan. 21	Anand	Dr.		5,000	
		To Cash				4,800
		To Discount				200
		(Being cash paid to Anand and he allowed ₹200 as discount)				
11.	Jan. 26	Cash A/c	Dr.		200	
		To Interest				200
		(Being receipt of interest)				
12.	Jan. 28	Interest on Loan	Dr.		500	
		To Cash				500
		(Being payment of interest on loan)				
13.	Jan. 31	Cash A/c	Dr.		500	
		To Sales A/c				500
		(Being goods sold for cash)				
14.	Jan. 31	Drawings A/c	Dr.		200	
		To Purchases A/c				200
		(Being goods withdrawn for personal use)				
		Total			96,900	96,900

Check Your Progress

1. What are the two types of real accounts?
2. State the three ways in which a compound journal entry can be recorded.

2.3 LEDGER

It has already been explained in the previous unit that accounting involves recording, classifying and summarising the financial transactions. Recording is done in the Journal. This has already been explained in the preceding chapter. Classifying of the recorded transactions is done in the Ledger. This is being explained in the present section.

Ledger is a book which contains various accounts. In other words, Ledger is a set of accounts. It contains all accounts of the business enterprise whether Real, Nominal or Personal. It may be kept in any of the following two forms:

(*i*) Bound Ledger (*ii*) Loose-leaf Ledger.

It is common to keep the Ledger in the form of loose-leaf cards these days. This helps in posting transactions particularly when mechanised system of accounting is used.

2.3.1 Posting

The term "Posting" means transferring the debit and credit items from the Journal to their respective accounts in the Ledger. It should be noted that the exact names of accounts used in the Journal should be carried to the Ledger. For example, if in the Journal, Expenses Account has been debited, it would not be correct to debit the Office Expenses Account in the Ledger. Though, in the Journal, it might have been indicated clearly in the narration that it is an item of office expenses the correct course would have been to record the amount to the Office Expenses Account in the Journal as well as in the Ledger.

Posting may be done at any time. However, it should be completed before the financial statements are prepared. It is advisable to keep the more active accounts posted to date. The examples of such accounts are the cash account, personal accounts of various parties etc.

The posting may be done by the book-keeper from the Journal to the Ledger by any of the following methods:

(*i*) He may take a particular side first. For example, he may take the debits first and make the complete postings of all debits from the Journal to the Ledger.

(*ii*) He may take a particular account and post all debits and credits relating to that account appearing on one particular page of the Journal. He may then take some other accounts and follow the same procedure.

(*iii*) He may complete postings of each journal entry before proceeding to the next journal entry.

It is advisable to follow the last method. One should post each debit and credit item as it appears in the Journal.

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The Ledger Folio (L.F.) column in the Journal is used at the time when debits and credits are posted to the Ledger. The page number of the Ledger on which the posting has been done is mentioned in the L.F. column of the Journal. Similarly, a folio column in the Ledger can also be kept where the page from which posting has been done from the Journal may be mentioned. Thus, there are cross references in both the Journal and the Ledger.

A proper index should be maintained in the Ledger giving the names of the accounts and the page numbers.

Relationship between Journal and Ledger

Both Journal and Ledger are the most important books used under Double Entry System of book-keeping. Their relationship can be expressed as follows:

(*i*) The transactions are recorded first of all in the Journal and then they are posted to the Ledger. Thus, the Journal is the book of first or original entry, while the Ledger is the book of second entry.

(*ii*) Journal records transactions in a chronological order, while the Ledger records transactions in an analytical order.

(*iii*) Journal is more reliable as compared to the Ledger since it is the book in which the entry is passed first of all.

(*iv*) The process of recording transactions is termed as "Journalising" while the process of recording transactions in the Ledger is called as "Posting".

Rules Regarding Posting

The following rules should be observed while posting transactions in the Ledger from the Journal:

(*i*) Separate accounts should be opened in the Ledger for posting transactions relating to different accounts recorded in the Journal. For example, separate accounts may be opened for sales, purchases, sales returns, purchases returns, salaries, rent, cash, etc.

(*ii*) The concerned account which has been debited in the Journal should also be debited in the Ledger. However, a reference should be made of the other account which has been credited in the Journal. For example, for salaries paid, the salaries account should be debited in the Ledger, but reference should be given of the Cash Account which was has been credited in the Journal.

(*iii*) The concerned account, which has been credited in the Journal should also be credited in the Ledger, but reference should be given of the account, which has been debited in the Journal. For example, for salaries paid, Cash Account has been credited in the Journal. It will be credited in the Ledger also, but reference will be given of the Salaries Account in the Ledger.

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Thus, it may be concluded that while making posting in the Ledger, the concerned account which has been debited or credited in the Journal should also be debited or credited in the Ledger, but reference has to be given of the other account which has been credited or debited in the Journal, as the case may be. This will be clear with the following example.

Suppose, salaries of ₹10,000 have been paid is cash; the following entry will be passed in the Journal:

Salaries Account	(i)	Dr.	10,000	
To Cash Account	(ii)			10,000

In the Ledger two accounts will be opened, (*i*) Salaries Account, and (*ii*) Cash Account. Since Salaries Account has been debited in the Journal, it will also be debited in the Ledger. Similarly, Cash Account has been credited in the Journal and, therefore, it will also be credited in the Ledger, but reference will be given of the other account involved. Thus, the accounts will appear as follows in the Ledger:

Dr. SALARIES ACCOUNT *Cr.*

	₹	*Particulars*
Cash A/c (*ii*)	10,000	

Dr. CASH ACCOUNT *Cr.*

Particulars	₹	*Particulars*	₹
		Salaries A/c (*i*)	10,000

Use of the words "To" and "By"

It is customary to use words 'To' and 'By' while making posting in the Ledger. The word 'To' is used with the accounts which appear on the debit side of a Ledger Account. For example, in the Salaries Account, instead of writing only "Cash" as shown above, the words "To Cash" will appear on the debit side of the account. Similarly, the word "By" is used with accounts which appear on the credit side of a Ledger Account. For example, in the above case, the words "By Salaries A/c" will appear on the credit side of the Cash Account instead of only "Salaries A/c". The words 'To' and 'By' do not have any specific meanings. Modern accountants are, therefore, ignoring the use of these words.

The procedure of posting from the Journal to the Ledger will be clear with the help of the illustrations given in the following pages.

Illustration 2.5. Journalize the following transactions and post them into the Ledger:

1. Ram started business with a capital of ₹10,000.
2. He purchased furniture for cash ₹4,000.

3. He purchased goods from Mohan on credit ₹2,000.
4. He paid cash to Mohan ₹1,000.

Solution:

NOTES

JOURNAL

	Date	Particulars		L.F.	Dr. ₹	Cr. ₹	
1		Cash Account	Dr.		10,000		
		To Capital Account				10,000	5
2		Furniture Account	Dr.		4,000		
		To Cash Account				4,000	6
3		Purchases Account	Dr.		2,000		
		To Mohan				2,000	7
4		Mohan	Dr.		1,000		
		To Cash Account				1,000	8

Ledger

CASH ACCOUNT

1	To Capital A/c	10,000	By Furniture A/c	4,000	6
			By Mohan	1,000	8

CAPITAL ACCOUNT

			By Cash A/c	10,000	5

FURNITURE ACCOUNT

2	To Cash A/c	4,000		

PURCHASES ACCOUNT

3	To Mohan	2,000		

MOHAN

4	To Cash A/c	1,000	By Purchases A/c	2,000	7

Balancing of an Account

In business, there may be several transactions relating to one particular account. In Journal, these transactions appear on different pages in a chronological order while they appear in a classified form under that particular account in the Ledger. At the end of a period (say, a month, a quarter or a year), the businessman will be interested in knowing the position of a particular account. This means, he should total the debits and credits of the account separately and find out the net balance. This technique of finding out the net balance of an account, after considering the totals of both debits and credits appearing in the account is known as 'Balancing the Account'. The balance is put on the side of the account which is smaller and a reference is given that it has been carried forward or carried down (*c/f* or *c/d*) to the next period. On the other hand, in the next period, a reference is given that the opening has been brought forward or brought down (*b/f* or *b/d*) from the previous period. This will be clear with the help of the following illustration.

Illustration 2.6. Journalize the following transactions, post them in the Ledger and balance the accounts on 31st January.

1. Ram started business with a capital of ₹10,000.
2. He purchased goods from Mohan on credit ₹2,000.
3. He Paid cash to Mohan ₹1,000.
4. He sold goods to Suresh ₹2,000.
5. He received cash from Suresh ₹3,000.
6. He further purchased goods from Mohan ₹2,000.
7. He paid cash to Mohan ₹1,000.
8. He further sold goods to Suresh ₹2,000.
9. He received cash from Suresh ₹1,000.

Solution:

JOURNAL

Particulars		*L.F.*	*Debit* (₹)	*Credit* (₹)
Cash Account	Dr.		10,000	
To Capital Account				10,000
(Being commencement of business)				
Purchases Account	Dr.		2,000	
To Mohan				2,000
(Being purchase of goods on credit)				
Mohan	Dr.		1,000	
To Cash				1,000
(Being payment of cash to Mohan)				
Suresh	Dr.		2,000	
To Sales				2,000
(Being goods sold to Suresh)				
Cash Account	Dr.		3,000	
To Suresh				3,000
(Being cash received from Suresh)				
Purchases Account	Dr.		2,000	
To Mohan				2,000
(Being purchase of goods from Mohan)				
Mohan	Dr.		1,000	
To Cash Account				1,000
(Being payment of cash to Mohan)				
Suresh	Dr.		2,000	
To Sales Account				2,000
(Being goods sold to Suresh)				
Cash Account	Dr.		1,000	
To Suresh				1,000
(Being cash received from Suresh)				
Total			24,000	24,000

NOTES

Ledger

Dr. CASH ACCOUNT *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
	To Capital A/c	10,000		By Mohan	1,000
	To Suresh	3,000		By Mohan	1,000
	To Suresh	1,000	Jan. 31	By Balance c/d	12,000
		14,000			14,000
Feb. 1	To Balance b/d	12,000			

Dr. CAPITAL ACCOUNT *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
Jan. 31	To Balance c/d	10,000		By Cash A/c	10,000
		10,000			10,000
			Feb. 1	By Balance b/d	10,000

PURCHASES ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
	To Mohan	2,000	Jan. 31	By Balance c/d	4,000
	To Mohan	2,000			
		4,000			4,000
Feb. 1	To Balance b/d	4,000			

MOHAN

Date	*Particulars*	₹	*Date*	*Particulars*	₹
	To Cash	1,000		By Purchases	2,000
	To Cash	1,000		By Purchases	2,000
	To Balance c/d	2,000			
		4,000			4,000
			Feb. 1	By Balance b/d	2,000

SURESH

Date	*Particulars*	₹	*Date*	*Particulars*	₹
	To Sales	2,000		By Cash A/c	3,000
	To Sales	2,000		By Cash A/c	1,000
		4,000			4,000

SALES ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
Jan. 31	To Balance c/d	4,000		By Suresh	2,000
	By Suresh				2,000
		4,000			4,000
			Feb. 1	By Balance b/d	4,000

It is to be noted that the balance of an account is always known by the side which is greater. For example, in the above illustration, the debit side of the Cash Account is greater than the credit side by ₹12,000. It will be, therefore, said that Cash Account is showing a debit balance of

₹12,000. Similarly, the credit side of the Capital Account is greater than debit side by ₹10,000. It will be, therefore, said that the Capital Account is showing a credit balance of ₹10,000.

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2.4 SUB-DIVISION OF JOURNALS (SUBSIDIARY BOOKS)

Let us study the different types of Journals.

1. General Journal

It is also known as Journal Proper. It is meant for recording all such transactions for which no special journal has been kept by the business. As a matter of fact, it is meant for recording such transactions which do not occur frequently in the business and, therefore, do not warrant setting up of special journals. Examples of such transactions are as follows:

(*i*) **Opening entries** When a new set of books is started, the old accounts have to be brought forward in the beginning of the year from last year's books. The opening entry is meant for recording these transactions. The entries are made from the balance sheet of the last year.

(*ii*) **Closing entries** At the end of accounting year, the nominal accounts are closed by transferring them to trading account or profit and loss account. The entries passed for this purpose are termed as 'Closing Entries'.

(*iii*) **Adjustment entries** At the end of the accounting year, adjustment entries are to be passed for outstanding/prepaid expenses, accrued/outstanding income etc. Entries for all these adjustment are passed in the General Journal.

(*iv*) **Transfer entries** Transfer entries are required for transferring one account to the other. Entries for such transfer are passed in the General Journal.

(*v*) **Rectification entries** Rectification entries are passed for rectifying the errors which might have been committed in the books of account. For example, the account of Mohan might have been debited in place of the account of Sohan. The necessary rectifying entry will be passed in he General Journal.

(*vi*) **Purchases of fixed assets** The entries for purchases of fixed assets such as plant, machinery, furniture, etc., on credit are also passed in this Journal.

2. Special Journal

The term 'Special Journal' means a Journal which is meant for a special purpose. The following are the various types of Special Journals.

(*i*) **Cash Journal** Cash Journal is meant for recording all cash transactions. It may be further classified into Cash Receipts Journal and Cash Payments Journal. Cash Receipts Journal records all cash receipts while Cash Payments Journal records all cash payments.

(*ii*) **Goods Journal** The Journal is meant for recording all transactions relating to goods. It may, further, be classified into the following categories:

(*a*) *Purchases Journal* The Journal is meant for recording all credit purchases of goods. Cash purchases are to be recorded in the Cash Journal. Moreover, only purchases of goods is to be recorded in this Journal. The term "goods" means articles purchased for resale.

(*b*) *Sales Journal* The Journal is meant for recording all credit sales of goods. Cash sales of the goods are to be recorded in the Cash Journal.

(*c*) *Purchases Returns Journal* It is meant for recording all returns of goods purchased on credit. It is also known as *Returns Outward Journal.*

(*d*) *Sales Returns Journal* It is meant for recording all return of goods sold on credit. It is also known as *Returns Inward Journal.*

(*iii*) **Bills Journal** The Journal is meant for recording all bills of exchange or promissory notes received or issued by the business. It can be classified into two categories:

(*a*) *Bills Receivable Journal* It is meant for recording all bills of exchange or promissory notes received by the business from its debtors.

(*b*) *Bills Payable Journal* It is meant for recording all bills of exchange or promissory notes issued by the business in favour of its creditors.

Transactions relating to bills of exchange and promissory notes have been explained later in a separate unit.

In the following pages, we are explaining the method of recording business transactions in each Journal and their posting into the ledger.

2.4.1 Cash Journal or Book

Cash Journal or Cash book is meant for recording all cash transactions. It is a very important Journal of business on account of the following reasons:

(*i*) The number of cash transactions is quite large in every business. The business has to pay for salaries, rent, lighting, insurance, purchase of

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goods and it has to receive cash for sales of goods and capital assets.

(*ii*) The chances of fraud being committed regarding cash are higher as compared to other assets. A strict control is, therefore, required. A properly maintained cash book helps in achieving this objective.

(*iii*) Cash is the nerve centre of the business. Timely payments to its creditors increases the reputation of the business. Similarly timely payments from its debtors improves the financial position of the business.

The cash book can be of any of the following types:

(*i*) Simple Cash Book

(*ii*) Two-Columnar Cash Book

(*iii*) Three-Columnar Cash Book

(*iv*) Multi-Columnar Cash Book

(*v*) Cash Receipts Book

(*vi*) Cash Payments Book

(i) Simple (Single)-Columnar Cash Book

Simple Cash Book is like an ordinary cash account. Its proforma is given below:

Dr. SIMPLE CASH BOOK *Cr.*

Date	*Particulars*	*L.F.*	*Amount*	*Date*	*Particulars*	*L.F.*	*Amount*

The recording of the transactions in the Simple Cash Book and their posting in the Ledger can be understood with the help of the following illustration:

Illustration 2.7. Record the following transactions in the Cash Book and post them in the ledger:

Jan.	01	Opening Cash balance ₹5,000.
Jan.	04	Rent paid ₹2,000
Jan.	06	Interest received ₹3,000.
Jan.	15	Cash purchases ₹4,000.
Jan.	25	Cash sales ₹8,000.
Jan.	31	Salaries paid ₹2,000.

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Solution:

Dr. CASH BOOK Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)
Jan. 1	To Balance b/d		5,000	Jan. 4	By Rent		2,000 1
Jan. 2	To Interest	4	3,000	Jan. 15	By Purchases A/c		4,000 2
Jan. 25	To Sales	5	8,000	Jan. 31	By Salaries A/c		2,000 3
				Jan. 31	By Balance c/d		8,000
			16,000				16,000
	To Balance b/d		8,000				

Ledger

Dr. INTEREST ACCOUNT Cr.

	4	By Cash A/c	3,000

SALES ACCOUNT

	5	By Cash A/c	8,000

RENT ACCOUNT

To Cash A/c	2,000	1	

PURCHASES ACCOUNT

To Cash A/c	4,000	2	

SALARIES ACCOUNT

To Cash A/c	2,000	3	

It should be noted that in the ledger no separate cash account will be opened. The Cash Book functions both as a book as well as an account as shown in the illustration above.

(ii) Two (Double)-Columnar Cash Book

Such a Cash Book has two columns: (*i*) Cash Column, and (*ii*) Discount Column. Cash column is meant for recording cash receipts and payments while discount column is meant for recording discount received and the discount allowed. The discount column on the debit side represents the discount allowed while discount column on the credit side represents the discount received.

It should be noted that while the cash column of the cash book serves both the functions of a book as well as an account but discount column does not serve the function of a discount account. A separate discount account has to be opened in the ledger in which total debits and credits from the Cash Book are posted. Sometimes, two separate discount accounts are kept in the ledger—one for discount allowed and the other for discount received.

Trade Discount and Cash Discount The following are the points of distinction between trade discount and cash discount:

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(*i*) Trade discount is a deduction granted by a supplier from the list price of the goods due to large quantity of sales or business tradition. While cash discount is allowed by the creditor to the debtor for either buying in cash or for making payment before the stipulated period.

(*ii*) Trade discount is allowed on sale of goods while cash discount is allowed on payment of money.

(*iii*) Trade discount is not recorded in the books of account. The goods are recorded on the net price. While cash discount is shown in the books of account.

(*iv*) Trade discount may vary with the quantity of goods purchased while cash discount may vary with the time period.

The recording of transactions in a two columnar cash book will be clear with the help of the following illustration:

Illustration 2.8. Record the following transactions in the Cash Book and post them in the ledger:

1. Jan. 01	Cash balance ₹5,000.
2. Jan. 06	Sold goods to Mahesh ₹4,000.
3. Jan. 08	Purchased goods from Mukesh ₹3,000.
4. Jan. 15	Cash received from Mukesh ₹3,900 in full satisfaction.
5. Jan. 20	Paid to Mukesh ₹2,830 in full satisfaction.
6. Jan. 25	Sold goods to Suresh ₹3,000.
7. Jan. 31	Received cash from Suresh ₹2,900 in full satisfaction.

Solution:

Dr. CASH BOOK *Cr.*

Date	*Particulars*	*L.F.*	*Discount (₹)*	*Cash ₹*	*Date*	*Particulars*	*L.F.*	*Discount (₹)*	*Cash (₹)*
Jan. 1	To Balance b/d			5,000	Jan. 20	By Mukesh		150	2,850
Jan. 25	To Mahesh		100	3,900	Jan. 31	By Balance c/d			8,950
Jan. 31	To Suresh		100	2,900					
			200	11,800				150	11,800

Ledger

MAHESH

Date	*Particulars*	₹	*Date*	*Particulars*	₹
Jan. 6	To Sales A/c	4,000	Jan. 15	By Cash A/c	3,900
			Jan. 15	By Discount A/c	100

NOTES

SURESH

Date	Particulars	₹	Date	Particulars	₹
Jan. 25	To Sales A/c	3,000	Jan. 31	By Cash	2,900
			Jan. 31	By Discount	100

MUKESH

Date	Particulars	₹	Date	Particulars	₹
Jan. 20	To Cash	2,850	Jan. 8	By Purchases A/c	3,000
Jan. 20	To Discount	150			

DISCOUNT ALLOWED ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Sundries	200			

DISCOUNT RECEIVED ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
			Jan. 31	By Sundries	150

Notes:

1. Transactions 2 and 6 relate to credit sales of goods and, therefore, they have not been recorded in the cash book. They will be recorded in the Sales Book and the posting will be done in the personal account of Mahesh and Suresh from there as shown in the Ledger.
2. Transaction 3 relates to credit purchase of goods. It has, therefore, not been recorded in the Cash Book. It will be recorded in the Purchases Book from where posting will be done in the personal account of Mukesh as shown in the Ledger.
3. The total of the debit side of the discount column has been taken to the 'Discount Allowed Account' in the ledger. The word 'sundries' has been put in the 'particulars' column. Any person who is interested in knowing the person to whom the discount has been allowed can find it out from the Cash Book.
4. The total of the discount column appearing on the credit side of the cash book has been taken to 'Discount Received Account' in the ledger. The word 'Sundries' has been put in the 'Particulars' column. Any person who is interested in knowing the names of the persons form whom the discount has been received can find it out from the cash book.

(iii) Three-Columnar Cash Book

This type of cash book contains the following three columns on each side:

(*i*) Cash column for cash received and cash paid.

(*ii*) Discount column for discount received and discount allowed.

(*iii*) Bank column for money deposited and money withdrawn from the bank.

The proforma of such a Cash Book is as follows:

Dt.	*Particulars*	*L.F.*	*Discount*	*Cash*	*Bank*	*Dt.*	*Particulars*	*L.F.*	*Discount*	*Cash*	*Bank*

The recording of transactions in three-columnar cash book will be clear with the help of the following Illustration.

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Illustration 2.9.

Jan. 01	Opening Balance :	Cash ₹3,000
		Bank ₹4,000
Jan. 04	Rent paid by cheque ₹2,000	
Jan. 06	Received on account of cash sales ₹3,000.	
Jan. 08	Paid to Mehta Bros. by cheque ₹2,000 and earned ₹200 as cash discount.	
Jan. 10	Received from Suresh by cheque ₹2,000 and allowed him ₹100 as cash discount.	
Jan. 12	Cash sales ₹20,000.	
Jan. 20	Cash purchases ₹15,000.	
Jan. 31	Salaries paid ₹5,000.	

Solution:

CASH BOOK

Dt.	*Particulars*	*L.F*	*Discount (₹)*	*Cash (₹)*	*Bank (₹)*	*Dt.*	*Particulars*	*L.F.*	*Discount (₹)*	*Cash (₹)*	*Bank (₹)*
Jan.						Jan.					
1	To Balance 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 Purch. A/c			15,000	
12	To Sales A/c			20,000		31	By Salaries A/c			5,000	
						31	By Balance c/d			6,000	2,000
			100	26,000	6,000				200	26,000	6,000
	To Balance b/d			6,000	2,000						

Ledger

Dr. SALES ACCOUNT *Cr.*

Date	*Particulars*	*Amount (₹)*	*Date*	*Particulars*	*Amount (₹)*
			Jan. 1	By Cash A/c	3,000
			Jan. 10	By Cash A/c	20,000

SURESH

			Jan. 10	By Bank A/c	2,000
				By Discount A/c	100

RENT ACCOUNT

Jan. 4	To Bank A/c		2,000		

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MEHTA BROS

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 8 Jan. 8	To Bank A/c To Discount A/c	2,000 100			

PURCHASES ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 20	To Cash A/c	15,000			

SALARIES ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 31	To Cash A/c	5,000			

DISCOUNT ALLOWED ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 31	To Sundries A/c	100			

DISCOUNT RECEIVED ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			Jan. 31	By Sundries	200

Contra entry As explained above, a three columnar cash book contains columns both for cash and bank transactions. An accounting transaction involves two accounts and there may be a transaction where both Cash Account and Bank Account are involved. Since in the ledger, there are no separate Cash Account and Bank Account, therefore, no posting will be done from the Cash Book to the Ledger in case of such a transaction. The transaction will be recorded on both sides of the Cash Book. For example, if cash is withdrawn from the bank, the two accounts involved are the Cash Account and the Bank, Account. In the Cash Book, on the debit side, the amount will be put in cash column against the words "To Bank" while on the credit side of the Cash Book, the amount will be written in the bank column against the words "By Cash". Such an accounting entry which is recorded on both the debit and credit sides of the cash book is known as a Contra Entry. In order to give a hint to the ledger-keeper, that no posting is required for such an entry, the word 'C' is put in the ledger folio column on both the sides of the Cash Book.

Special points regarding cheques A business may receive cheques from its customers or it can issue cheques in favour of its customers or other creditors. Following are some special points which should be kept in view while making accounting entries in the Cash Book regarding such cheques received or issued.

1. *Receipt of cheques* There can be two situations:

(*A*) A cheque may be received by the business and sent to the Bank the same day for collection. In such a case, it will be better to put the cheque received in the debit side of the bank column as soon as it is received. For example, if on January 10, a cheque is received from *A* for ₹10,000 and is sent to the Bank for collection on the same day, the entry for receipt of the cheque will appear in the Cash Book as follows:

CASH BOOK (RECEIPTS SIDE)

Date	*Particulars*	*Date*	*Cash* (₹)	*Bank* (₹)
Jan. 10	To *A*			10,000

(*B*) In case a cheque received from a party is sent to the Bank at a later date, it will be better to take the cheque as receipt of cash when it is received and deposit of cash in the bank when the cheque is sent for collection to the Bank. For example, if on January 10, a cheque is received from *A* for ₹10,000 and is sent to the Bank for collection on January 14, the entries in the Cash Book will appear as follows:

Dr. CASH BOOK (CASH AND BANK COLUMNS) *Cr.*

Date	*Particulars*	*L.F.*	*Cash* (₹)	*Bank* (₹)	*Date*	*Particulars*	*L.F.*	*Cash* (₹)	*Bank* (₹)
Jan. 10	To *A*		10,000		Jan. 14	By Bank	*C*	10,000	
Jan. 14	To Cash	*C*		10,000					

Tutorial Note. In the absence of any specific instructions in the question, the students should presume that the cheque received from a party was sent to the Bank the same day for collection.

2. *Endorsement of cheques received* A cheque received by the business may not be sent by it to the Bank for collection, but may be endorsed by the business in favour of a creditor of the business. In such a case, the cheque received will be taken as a receipt of cash. Similarly, the cheque endorsed, will be taken as payment of cash. For example, if on January 10, cheque was received from *A* for ₹10,000 and it was endorsed on January 14 in favour of *B*, a creditor of the business, the entries in the Cash Book will appear as follows:

CASH BOOK (CASH COLUMN ONLY)

Date	*Particulars*	*L.F.*	*Amount*	*Date*	*Particulars*	*L.F.*	*Amount*
Jan. 10	To *A*		10,000	Jan. 14	By *B*		10,000

3. *Dishonour of cheques* The term 'dishonour of cheque' means non-payment of the cheque by the drawee Bank on its being presented for payment. There can be two different situations.

(*I*) A cheque received by a business and sent to the Bank for collection may be dishonoured on presentation for payment. In such a case, the

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party from whom the cheque was received should be debited while the account of the Bank should be credited. For example, if a cheque received from, *'A'* for ₹10,000 on January 10, is dishonoured by his bankers on presentation for payment on January 14, entries in the Cash Book will appear as follows:

Dr. CASH BOOK (BANK COLUMN) *Cr.*

Date	*Particulars*	*L.F.*	*Amount*	*Date*	*Particulars*	*L.F.*	*Amount*
Jan. 10	To *A*		10,000	Jan. 14	By *A*		10,000

Similarly when a cheque received from customer and endorsed in favour of a creditor is dishonoured, the entries to be passed in the Cash Book can be well understood on the basis of the following journal entries:

(a) On receipt of cheque

Cash A/c Dr.

To Customer

(b) On endorsement of cheque

Creditor Dr.

To Cash

(c) On dishonour of the cheque

Customer Dr.

To Creditor

Thus, it is clear that no entries will be passed in the Cash Book in the event of dishonour of a cheque received from a customer and endorsed in favour of a creditor. Entries (*a*) and (*b*) will be passed through the Cash Book while entry (*c*) will be passed through the Journal Proper.

(*II*) Cheques issued by the business in favour of third parties may be dishonoured by the Bank. In such a case, the entry to be passed on the Cash Book can be understood by passing the following journal entries:

(a) On issue of the cheque in favour of a creditor

Creditor Dr.

To Bank

(b) On dishonour of the cheque issued by the Bank

Bank Dr.

To Creditor

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Thus, when the cheque is issued in favour of a creditor, the creditor is debited and the Bank Account is credited. The entry will appear in the Cash Book on the credit side in the Bank column. On return of the cheque by the creditor on account of its non-payment, the Creditor's Account, which was previously debited, would now be credited while the Bank Account, which was previously credited, would now be debited. The entry for dishonour will, therefore, appear in the debit side of the Cash Book in the Bank column.

The recording of transactions in a three-columnar cash book and from there posting into the ledger will be clear with the help of the following illustration.

Illustration 2.10. Enter the following transactions in the appropriate type of the cash books, and post the same to the relevant ledger accounts:

2016		
July	01	Started business with an investment of ₹9,000.
July	02	Deposited in Bank of India, ₹7,000.
July	04	Acquired a building by issuing a cheque of ₹5,000.
July	10	Paid the bill of the furniture by cheque ₹1,000.
July	15	Purchased ₹800 of merchandise by cheque.
July	18	Withdrew ₹100 from the bank.
July	20	Sold merchandise for ₹1,200.
July	22	Deposited ₹2,000 into the bank.
July	25	Bought ₹1,000 merchandise.
July	26	Sold ₹1,500 merchandise by crossed cheque.
July	27	Paid ₹100 by cheque as the premium for insuring building against fire.
July	28	Paid freight ₹50.
July	30	Withdrew from bank for personal use ₹500.
July	31	Cleared electricity bill ₹90.
July	31	Paid to Mahesh ₹1,080 in full satisfaction by cheque. We owed to Mahesh ₹1,100 for goods purchased.
July	31	Received from Suresh a cheque for ₹1,480, in full satisfaction of the debt of ₹1,510.

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Solution:

Dr. CASH BOOK *Cr.*

Dt.	*Particulars*	*L.F*	*Dis.* (₹)	*Bank* (₹)	*Cash* (₹)	*Dt.*	*Particulars*	*L.F.*	*Dis.* (₹)	*Bank* (₹)	*Cash* (₹)
2016						2016					
Jul. 1	To Capital				9,000	Jul. 2	By Bank	*C*			7,000
Jul. 2	To Cash	*C*		7,000		Jul. 4	By Building			5,000	
Jul. 18	To Bank	*C*			100	Jul. 10	By Furniture			1,000	
Jul. 20	To Sales				1,200	Jul. 15	By Purchases			800	
Jul. 22	To Cash	*C*		2,000		Jul. 18	By Cash	*C*		100	
Jul. 26	To Sales			1,500		Jul. 22	By Bank	*C*			2,000
Jul. 31	To Suresh		30	1,480		Jul. 25	By Purchases				1,000
						Jul. 27	By Insurance Premium			100	
						Jul. 28	By Freight				50
						Jul. 30	By Drawings			500	
						Jul. 31	By Electricity				90
						Jul. 31	By Mahesh		20	1,080	
						Jul. 31	By Bal. c/d			3,400	160
			30	11,980	10,300				20	11,980	10,300
Aug. 1	To Bal. b/d			3,400	160						

Ledger

Dr. CAPITAL ACCOUNT *Cr.*

Date	*Particulars*	*Amount* (₹)	*Date*	*Particulars*	*Amount* (₹)
			July 1	By Cash	9,000

BUILDING ACCOUNT

July 4	To Bank	5,000			

PURCHASES ACCOUNT

July 15	To Bank	800			
July 25	To Cash	1,000			

FREIGHT ACCOUNT

July 28	To Cash	50			

ELECTRICITY ACCOUNT

July 31	To Cash	90			

SALES ACCOUNT

			July 20	By Cash	1,200
			July 26	By Bank	1,500

FURNITURE ACCOUNT

July 10	To Bank	1,000			

INSURANCE PREMIUM ACCOUNT

July 27	To Bank	100			

DRAWINGS ACCOUNT

July 30	To Bank	500			

DISCOUNT ACCOUNT

July 31	To Sundries	35	July 31	By Sundries	20

Notes:

(*i*) Cash and Bank columns in the cash book serve the purpose of prime as well as final entries. Hence, in the ledger no Cash and Bank Accounts have been opened.

(*ii*) Cash Account never shows a credit balance, since a person cannot spend more than what he has. While, the Bank Account may show a credit balance, since a bank may permit a customer to overdraw his account (*i.e.*, withdraw more money than what he has in his account). In such a case, it will be said that the customer has an overdraft with the Bank.

(*iii*) Postings to the Discount Account is done at the end of the period with Total Discount Received and Total Discount Allowed.

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Cash Receipts and Payments Journal

It is common practice these days to keep separate Cash books for receipts and payments. Thus, the business maintains two Cash Journals: (*i*) Cash Receipts Journal, and (*ii*) Cash Payments Journal.

(*i*) **Cash Receipts Journal** The Journal is meant for recording all cash receipts. The posting is done daily from the Cash Receipts Book to the Journal. The concerned accounts are all credited with amount mentioned in the Cash Receipts Journal. The total cash received as shown by the Cash Receipts Journal is debited to the Cash Account at the end of a period usually at the end of a week.

(*ii*) **Cash Payments Journal** The book is meant for recording all cash payments. The posting is done daily from this book to the ledger and the concerned accounts are debited. At the end of a period (usually at the end of the week), cash account is credited with the total cash paid during the period.

2.4.2 Petty Cash Book

Petty Cash Book is maintained by the business to record petty cash expenses of the business, such as postage, cartage, stationery, cleaning charges etc. In every business, there are many payments like the above which are of small amounts. In case all these transactions are recorded in the Main Cash Book, their recording will not only be inconvenient but also consume a lot of valuable time of the cashier and the Posting Clerk. A Petty Cashier is appointed by the business to make payments of all such petty expenses. He

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works under the supervision of the Chief Cashier, who advances money in the beginning of every month/quarter to meet petty expenses. At the end of the month/quarter, the Petty Cashier submits a statement of account of the expenses incurred by him during the month/quarter and gets a fresh advance.

The Petty Cash Book is usually maintained on the basis of Imprest System. According to this system, a fixed amount is advanced to the Petty Cashier at the beginning of the period by the Chief Cashier. He submits his accounts at the end of the period and the Chief Cashier after examining his accounts gives him a fresh advance equivalent to the amount spent by him during the period. Thus, in the beginning of the each period (month or quarter as the case may be), the Petty Cashier has a fixed balance. The amount so advanced to him is termed as "Imprest" or "Float".

The recording of transactions in a Petty Cash Book will be clear with the help of the following Illustration.

Illustration 2.11. Enter the following transactions in the Petty Cash Book (maintained on Imprest system) for the month of January, 2015.

Jan. 01	Cash received from the Chief Cashier ₹200
Jan. 03	Typing paper ₹8, Postage ₹4
Jan. 06	Office cleaning ₹4
Jan. 08	Postage ₹2
Jan. 10	Cartage ₹2
Jan. 15	Postage ₹6
Jan. 18	Ink ₹3, Typing paper ₹10
Jan. 20	Typewriter ribbon ₹10
Jan. 22	Telephone charges ₹7
Jan. 24	Office cleaning ₹2
Jan. 25	Nailpolish ₹27
Jan. 27	Telegrams ₹25
Jan. 29	Typing paper ₹30

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Solution:

PETTY CASH BOOK

Receipts				*Payments*								
Date 2015	*Particulars*	*Cash Book Folio*	*Total* ₹	*Date*	*Particulars*	*Voucher Nos,*	*Station-ery* ₹	*Postal charges etc.* ₹	*Cartage*	*Cleaning* ₹	*Miscel-laneous* ₹	*Total* ₹
Jan. 1	To Cash from Chief			3	Typing paper, postage	1, 2	8	4				12
	Cashier		200	6	Office cleaning	3				4		4
				8	Postage, office cleaning	4, 5		2		2		4
				10	Cartage	6			2			2
				15	Postage	7		6				6
				18	Ink, typing paper	8, 9	13					13
				20	Typewriter ribbon	10	10					10
				22	Telephone charges	11		7				7
				24	Cleaning	12				2		2
				25	Nailpolish	13					27	27
				27	Telegrams	14		25				25
				29	Typing paper	15	30					30
							61	44	2	8	27	142
					Ledger Folio		2	3	4	5	6	
					Balance c/d							58
			200									200
Feb. 1	To Balance b/d		58									
Feb. 1	To Cash from Chief Cashier		142									

Note: Voucher numbers, Ledger Folio numbers are imaginary.

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Postings from the Petty Cash Book Postings in the Ledger from the Petty Cash Book is done at the end of the period, *i.e.,* month or quarter as the case may be. There are two alternative ways of making postings 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. This method is usually not followed.

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:

(i) 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)

(ii) 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.

Taking the figures as given in the preceding illustration, the various ledger accounts, according to the second method, will appear as follows:

Dr. PETTY CASH ACCOUNT *Cr.*

Date	*Particulars*	*Amount* (₹)	*Date*	*Particulars*	*Amount* (₹)
Jan. 1	To Cash	200	Jan. 3	By Stationery	61
				By Postal Charges	44
				By Cartage	2
				By Cleaning	8
				By Miscellaneous	27
				By Balance c/d	58
		200			200
Feb. 1	To Balance b/d	58			

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STATIONERY ACCOUNT

July 31	To Petty Cash A/c	61			

POSTAL CHARGES ACCOUNT

July 31	To Petty Cash A/c	71			

CARTAGE ACCOUNT

July 31	To Petty Cash A/c	2			

CLEANING ACCOUNT

July 31	To Petty Cash A/c	8			

MISCELLANEOUS expenses ACCOUNT

July 31	To Petty Cash A/c	27			

2.4.3 Purchases Journal

The Purchases 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. It should be noted that the book records only purchase of goods on credit. Purchases of items other than goods on credit is 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.

The following illustration will make clear the recording of transactions in the Purchases Journal and their subsequent posting in the ledger.

Illustration 2.12. Record the following transactions in the Purchases Journal and post them in the Ledger.

2016

Jan.	01	Purchased from Ram & Co. on credit:		
			30 Heater rods	@ ₹10
			20 Philips Bulbs	@ ₹20
Jan.	04	Purchased from Shyam & Co. on credit:		
			40 Heater rods	@ ₹10
			20 E.C.E. Bulbs	@ ₹15
Jan.	08	Purchased from Bajaj & Co. on credit:		
			20 Electric Elements	@ ₹40
			3 Electric Mixers	@ ₹100
Jan.	24	Purchased from K.C. & Co. on credit:		
			30 Electric Plugs	@ ₹20
			40 Table Fans	@ ₹200

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Solution:

PURCHASES JOURNAL

Sl. No.	Invoice No.	Particulars	L.F.	Amount (₹)	Amount (₹)
2016					
Jan. 1	50	Ram & Co.:	4		
		30 Heater rods @ ₹10		300	
		20 Philips Bulbs @ ₹20		400	700
Jan.4	55	Shyam & Co.:	8		
		40 Heater rods @ ₹10		400	
		20 E.C.E. Bulbs @ ₹15		300	700
Jan. 8	62	Bajaj & Co.:	12		
		20 Electric Elements @ ₹40		800	
		3 Electric Mixers @ ₹100		300	1,100
Jan. 24	65	K.C. & Co.:	13		
		30 Electric Plugs @ ₹20		600	
		40 Table Fans @ ₹200		8,000	8,600
Jan. 31		Purchases Account Dr.	14		11,100

Ledger

RAM & CO. (*Folio 4*)

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			Jan. 1	By Purchases	700

SHYAM & CO. (*Folio 8*)

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			Jan. 4	By Purchases	700

BAJAJ & CO. (*Folio 12*)

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			Jan. 8	By Purchases	1,100

K.C. & CO. (*Folio 13*)

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			Jan. 24	By Purchases	8,600

PURCHASES ACCOUNT (*Folio 14*)

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 31	To Sundries	11,100			

Notes:

(i) Folio Nos. are all imaginary.

(ii) Purchases Account has been debited with the total purchases made during the month. This has been done at the end of the month. A firm may make the posting in the Purchases Account weekly also.

(iii) Posting is done in the Personal Accounts daily.

Sales Journal

The Journal is meant for recording all sales of goods on credit. This is also known as Sales or Sold Day Book. It should be noted that Cash Sales are

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recorded in the Cash Book while sales of articles other than goods on credit is to be recorded in the General Journal.

Posting is done in the Personal Accounts daily from the Sales Book. They are debited with individual amounts. The Sales Account is credited with the total sales made during the period (*i.e.,* a week or month) at the end of the period.

The recording of the transactions in the Sales Book and their posting in the Ledger will be clear with the help of the following illustration.

Illustration 2.13. Record the following transactions in the Sales Day Book and post them into the ledger.

2015			
Jan. 01	Sold to Mukesh & Co.:		
		10 Heater Rods	@ ₹ 20
		10 Lamp Shades	@ ₹ 30
Jan. 10	Sold to Suresh & Brothers:		
		10 Table Fans	@ ₹ 250
		20 Philips Tubelights	@ ₹ 30
Jan. 25	Sold to Ramesh & Co.:		
		10 Electric Switches	@ ₹ 50
		20 E.C.E. Tubelights	@ ₹ 30

Solution:

SALES JOURNAL

Sl. No.	*Invoice No.*	*Particulars*	*L.F.*	*Amount* (₹)	*Amount* (₹)
Jan. 1	101	Mukesh & Co.:	4		
		10 Heater Rods @ ₹20		200	
		10 Lamp Shades @ ₹30		300	500
Jan.10	102	Suresh & Brothers:	6		
		10 Table Fans @ ₹250		2,500	
		20 Philips Tubelights @ ₹30		600	3,100
Jan. 25	103	Ramesh & Co.:	8		
		10 Electric Switches @ ₹50		500	
		20 E.C.E. Tubelights @ ₹30		600	1,100
		Sales A/c Cr.	10		4,700

Ledger

MUKESH & CO. (*Folio 4*)

Date	*Particulars*	*Amount* (₹)	*Date*	*Particulars*	*Amount* (₹)
Jan. 1	To Sales	500			

SURESH & BROTHERS *(Folio 6)*

Jan. 10	To Sales	3,100			

RAMESH & CO. (*Folio 8*)

Jan. 25	To Sales	1,100			

SALES ACCOUNT *(Folio 10)*

			Jan. 31	By Sundries	4,700

Notes:

(i) Folio Nos., Invoice Nos. are all imaginary.

(ii) Posting is done in the Personal Accounts daily. The total sales are posted at the end of the month (or week) on the credit side of the Sales Account, against the word 'Sundries'. Any person interested in finding out the names of the parties to whom the sales have been made can do so by looking to the Sales Book.

2.4.4 Sales Returns Journal

The 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 Returns Journal. They are recorded in the Cash Book in case cash is paid for them or no entry will be passed in case they have been recorded in a memorandum book only. A proforma of Sales Returns Journal is as under:

SALES RETURNS JOURNAL

Date	*Credit Note No.*	*Particulars*	*L.F.*	*Amount* (₹)	*Amount* (₹)
Jan. 10	202	Ram & Co.:			
		5 Electric Plugs @ ₹20		100	
		3 Philips Tubelights @ ₹30		90	190
		Sales Returns A/c Dr.			190

The posting from the Sales Returns Journal will be done daily in the personal accounts. For example, in the above case, the account of Ram & Co. will be credited with a sum of ₹190 on Jan. 10. The total of the Sales Returns Journal will be posted to the debit of Sales Returns Account at the end of the period, say, a week or a month.

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. The Note is prepared in duplicate. Its Proforma is as under:

MAHESHWARI BROTHERS

3, Strand Road, Kolkata

No. 202 Date Jan. 10, 2016

To

Ram & Co.,

21, Shri Ram Road, Delhi.

Dear Sir,

We have credited your account in respect of the following goods returned by you:

		₹	₹
(*i*) 5 Electric Plugs	@ ₹20	100	
(*ii*) 3 Philips Tubelights	@ ₹30	90	190

For Maheshwari Brothers

Sunil

Manager

2.4.5 Purchases Returns 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 receipt 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. A proforma of the Purchases Returns Journal is given below:

PURCHASES RETURNS JOURNAL

Date	*Credit Note No.*	*Particulars*	*L.F.*	*Amount* ₹	*Amount* ₹
Jan. 12	301	Shyam & Co.			
		3 Electric Rods @ ₹40			120
Jan. 21	302	Bajaj & Co.			
		3 Electric Mixers @ ₹300			900
		Purchases Returns A/c Cr.			1,020

Note: The entries in the Personal Accounts are done daily from the Purchases Returns Book. They are debited with the respective amounts. The total of the Purchases Returns Book is posted to the credit of Purchases Returns Account at the end of the period, say, a week or a month, as the case may be.

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. Its proforma is given as under:

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MAHESHWARI BROTHERS

3, Strand Road Kolkata

No. 301 Date Jan. 12, 2014

To

Shyam & Co.

3, Clive Road, Kolkata.

Dear Sir.

We have debited your account for the goods returned by us as under:

4 Electric Rods @ ₹30 ₹120

For Maheshwari Brothers

Sunil

Manager

Thus, in case of purchases returns or sales returns of goods, the flow of *Debit Note* or *Credit Note* can be put as follows:

(i) The Debit Note is sent by the Purchaser of goods to the Seller of goods on return of goods by the Purchaser to the Seller.

(ii) The Credit Note is sent by the Seller of goods to the Purchaser of goods on return of goods to the Seller by the Purchaser.

2.5 TRIAL BALANCE

In case the various debit balances and the credit balances of the different accounts are taken down in a statement, the statement so prepared is termed as a Trial Balance. In other words, Trial Balance is a statement containing the various ledger balances on a particular date.

Objects of Preparing a Trial Balance

1. *Checking of the arithmetical accuracy of the accounting entries* As indicated above, Trial Balance helps in knowing the arithmetical accuracy of the accounting entries. This is because according to the dual aspect concept for every debit, there must be an equivalent credit. Trial Balance represents a summary of all ledger balances and, therefore, if the two sides of the Trial Balance tally, it is an indication of this fact that the books of account are arithmetically accurate. Of course, there may be certain errors in the books of account in spite of an agreed Trial Balance. For example, if a transaction has been completely omitted from the books of account, the two sides of the Trial Balance will tally, in spite of the books of account being wrong. This has been discussed in detail later in a separate unit.

2. *Basis for financial statements* Trial Balance forms the basis for preparing financial statements such as the Income Statement and the Balance Sheet. The Trial Balance represents all transactions relating to different accounts in a summarised form for a particular period. In case the Trial Balance is not prepared, it will be almost impossible to prepare the financial statements as stated above to know the profit or loss made by the business during a particular period or its financial position on a particular date.
3. *Summarised ledger* It has already been stated that a Trial Balance contains the ledger balances on a particular date. Thus, the entire ledger is summarised in the form of a Trial Balance. The position of a particular account can be judged simply by looking at the Trial Balance. The Ledger may be seen only when details regarding the accounts are required.

Methods of Preparation of a Trial Balance

A Trial Balance may be prepared according to any of the two methods:

1. **Total Method** In case of this method after totaling each side of the ledger account, the respective debit and credit totals of the ledger accounts are transferred to the respective sides of the trial balance. Thus, in case of this method, the trial balance can be prepared soon after totaling various accounts and the time taken in balancing the account is saved to that extent. This method is not generally followed since it does not help in preparation of financial statements.
2. **Balance Method** According to this method, every ledger account is balanced and only the balance of the ledger account is carried forward to the trial balance. This method is generally used since the preparation of the financial statements where only balances are to be taken.
3. **Total and Balance Method** This method combines the first two methods explained above. In case of this method, the trial balance contains both the totals of both sides of the respective accounts as well as their final balances. This method has the advantage that it helps in immediate location of a mistake incurred, if any in the balancing the account. However, it has disadvantage of increasing the workload of the staff.

Illustration 2.14. Prepare (*a*) ledger accounts and (*b*) the trial balance according to (*i*) Total method (*ii*) Balance method and (*iii*) Total and balance method on the basis of transactions.

NOTES

Solution:

(*a*) Preparation of Ledger Accounts

Dr. CASH ACCOUNT Cr.

Date	Particulars	L.F.	₹	Date	Particulars	L.F.	₹
2016				2016			
Jan. 1	To Balance b/d		8,000	Jan. 1	By Purchases A/c		3,800
Jan. 4	To Vijay		1,980	Jan. 8	By Plant A/c		300
Jan. 15	To Rahim		300	Jan. 20	By Salary A/c		2,000
Jan. 18	To Sales A/c		1,000	Jan. 21	By Anand		4,800
Jan. 26	To Interest A/c		200	Jan. 28	By Interest on Loan A/c		500
Jan. 31	To Sales A/c		500	Jan. 31	By Balance c/d		580
			11,980				11,980
Feb. 1	To Balance b/d		580				

INTEREST ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	200	Jan. 26	By Cash A/c	200
		200			200
			Feb. 1	By Balance b/d	200

BANK ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	25,000	Jan. 31	By Balance c/d	25,000
		25,000			25,000
Feb. 1	To Balance b/d	25,000			

STOCK ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	20,000	Jan. 31	By Balance c/d	20,000
		20,000			20,000
Feb. 1	To Balance b/d	20,000			

Dr. FURNITURE ACCOUNT *Cr.*

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	2,000	Jan. 31	By Balance c/d	2,000
		2,000			2,000
Feb. 1	To Balance b/d	2,000			

BUILDING ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	10,000	Jan. 31	By Balance c/d	10,000
		10,000			10,000
Feb. 1	To Balance b/d	10,000			

VIJAY

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	2,000	Jan. 4	By Cash A/c	1,980
				By Discount A/c	20
		2,000			2,000

NOTES

ANIL

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	1,000	Jan. 31	By Balance c/d	1,000
		1,000			1,000
Feb. 1	To Balance b/d	1,000			

MADHU

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	2,000	Jan. 31	By Balance c/d	2,000
		2,000			2,000
Feb. 1	To Balance b/d	2,000			

ANAND

Date	Particulars	₹	Date	Particulars	₹
Jan. 21	To Cash A/c	4,800	Jan. 1	By Balance b/d	5,000
Jan. 21	To Discount A/c	200			
		5,000			5,000

CAPITAL ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	55,000	Jan. 1	By Balance b/d	55,000
		55,000			55,000
			Feb. 1	By Balance b/d	55,000

Dr. BABU'S LOAN ACCOUNT *Cr.*

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	10,000	Jan. 1	By Balance b/d	10,000
		10,000			10,000
			Feb. 1	By Balance b/d	10,000

PURCHASES ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Cash A/c	3,800	Jan. 31	By Drawings A/c	200
Jan. 1	To Discount A/c	200	Jan. 31	By Balance c/d	8,800
Jan. 6	To Bharat	5,000			
		9,000			9,000
Feb. 1	To Balance b/d	8,800			

DISCOUNT ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 4	To Vijay	20	Jan. 1	By Purchases A/c	200
Jan. 31	To Balance c/d	380	Jan. 21	By Anand	200
		400			400
			Feb. 1	By Balance b/d	380

BHARAT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	5,000	Jan. 6	By Purchases A/c	5,000
		5,000			5,000
			Feb. 1	By Balance b/d	5,000

NOTES

PLANT ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 8	To Mukesh	5,000	Jan. 31	By Balance c/d	5,300
Jan. 8	To Cash A/c	300			
		5,300			5,300
Feb. 1	To Balance b/d	5,300			

INTEREST ON LOAN ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
28	To Cash A/c	500	Jan. 31	By Balance c/d	500
		500			500
Feb. 1	To Balance b/d	500			

Dr. MUKESH *Cr.*

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	5,000	Jan. 8	By Plant A/c	5,000
		5,000			5,000
			Feb. 1	By Balance b/d	5,000

SALES ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	2,100	Jan. 21	By Rahim	600
			Jan. 18	By Cash A/c	1,000
			Jan. 31	By Cash A/c	500
		2,100			2,100
			Feb. 1	By Balance b/d	2,100

Dr. RAHIM *Cr.*

Date	Particulars	₹	Date	Particulars	₹
Jan. 12	To Sales A/c	600	Jan. 15	By Cash A/c	300
			Jan. 15	By Bad Debts A/c	300
		600			600

BAD DEBTS ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 15	To Rahim	300	Jan. 31	By Balance c/d	300
		300			300
Feb. 1	To Balance b/d	300			

SALARY ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 20	To Cash A/c	2,000	Jan. 31	By Balance c/d	2,000
		2,000			2,000
Feb. 1	To Balance b/d	2,000			

DRAWINGS ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Purchases A/c	200	Jan. 31	By Balance c/d	200
		200			200
Feb. 1	To Balance b/d	200			

NOTES

(*b*) (*i*) Total Method

TRIAL BALANCE

(as on 31st January, 2016)

Particulars	Debit (₹)	Credit (₹)
Cash Account	11,980	11,400
Interest Account		200
Bank Account	25,000	
Stock Account	20,000	
Furniture Account	2,000	
Building Account	10,000	
Vijay	2,000	2,000
Anil	1,000	
Madhu	2,000	
Anand	5,000	5,000
Capital Account		55,000
Babu's Loan Account		10,000
Purchases Account	9,000	200
Discount Account	20	400
Bharat		5,000
Plant Account	5,300	
Interest on Loan Account	500	
Mukesh		5,000
Sales Account		2,100
Rahim	600	600
Bad Debts Account	300	
Salary Account	2,000	
Drawings Account	200	
Total	96,900	96,900

(*ii*) Balance Method

TRIAL BALANCE

(as on 31st January, 2016)

Particulars	Debit (₹)	Credit (₹)
Cash Account	580	
Interest		200
Bank Account	25,000	
Stock Account	20,000	
Furniture Account	2,000	
Building Account	10,000	
Anil	1,000	
Madhu	2,000	
Capital Account		55,000
Babu's Loan Account		10,000
Purchases Account	8,800	
Discount Account		380

NOTES

Bharat		5,000
Plant Account	5,300	
Interest on Loan Account	500	
Mukesh		5,000
Sales Account		2,100
Bad Debts Account	300	
Salary Account	2,000	
Drawings Account	200	
	77,680	77,680

(*iii*) Total and Balance Method

TRIAL BALANCE

(as on 31st January, 2016)

Particulars	*Total Method*		*Balance Method*	
	Debit (₹)	*Credit* (₹)	*Debit* (₹)	*Credit* (₹)
Cash Account	11,980	11400	580	
Interest Account		200		200
Bank Account	25,000		25,000	
Stock Account	20,000		20,000	
Furniture Account	2,000		2,000	
Building Account	10,000		10,000	
Vijay	2,000	2,000		
Anil	1,000		1,000	
Madhu	2,000		2,000	
Anand	5,000	5,000		
Capital Account		55,000		55,000
Babu's Loan Account		10,000		10,000
Purchases Account	9,000	200	8,800	
Discount Account	20	400		380
Bharat		5,000		5,000
Plant Account	5,300		5,300	
Interest on Loan Account	500		500	
Mukesh		5,000		5,000
Sales Account		2,100		2,100
Rahim	600	600		
Bad Debts Account	300		300	
Salary Account	2,000		2,000	
Drawings Account	200		200	
Total	96,900	96,900	77,680	77,680

Check Your Progress

3. What is a credit note?
4. What is a special journal?

2.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. The two types of real accounts are:
   - o Tangible real account
   - o Intangible real account
2. It may be recorded in any of the following three ways:
   - One particular account may be debited while several other accounts may be credited.
   - One particular account may be credited while several other accounts may be debited.
   - Several accounts may be debited and several other accounts may also be credited.
3. The customer who returns the goods, gets credit for the value of goods returned. A credit note is sent to him intimating that his account has been credited with the value of goods returned.
4. The term special journal means a journal which is meant for a special purpose.

2.7 SUMMARY

- The Journal records all daily transactions of a business into the order in which they occur. A Journal may, therefore, be defined as a book containing a chronological record of transactions. It is the book in which the transactions are recorded first of all under the double entry system. Thus, Journal is the book of original record.
- The transactions in the Journal are recorded on the basis of the rules of debit and credit. For this purpose business transactions have been classified into three categories:
  - (i) Transactions relating to persons.
  - (ii) Transactions relating to properties and assets.
  - (iii) Transactions relating to incomes and expenses.
- Personal accounts include the accounts of persons with whom the business deals.
- Nominal accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. For example, in a business, salary is paid to the manager, rent is paid to the landlord, commission is paid to the salesman—cash goes out of the business and it is something real; while salary, rent or commission as such do not exist.

NOTES

- Sometimes there are a number of transactions on the same date relating to one particular account or of one particular nature. Such transactions may be recorded by means of a single journal entry instead of passing several journal entries. Such entry regarding recording a number of transactions is termed as a “Compound Journal 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 Assets Accounts are debited while all Liabilities Accounts are credited.
- In case the various debit balances and the credit balances of different accounts are taken down in a statement, the statement so prepared is termed as a trial balance.

2.8 KEY WORDS

- **Compound Journal Entry:** A journal entry recording more than one business transaction
- **Journal:** A book containing a chronological record of business transactions. It is the book of original records
- **Journalizing:** The process of recording transactions in the journal
- **Nominal Accounts:** These are the accounts opened in the books simply to explain the nature of the transaction. They include accounts of all incomes/gains and expenses/losses
- **Opening Journal Entry:** A journal entry passed for bringing forward balances of assets and liabilities of the previous period to the current period

2.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the stages of accounting cycle.
2. What are the rules of debit and credit?
3. What are the different categories of personal accounts?
4. What are the objects of preparing a trial balance?

Long Answer Questions

1. Analyse the different stages of an accounting cycle.
2. Explain the operation of cash receipts and payments journal.

3. Explain the different rules for journalising the transaction with appropriate illustrations.
4. Briefly explain the difference between:
   (i) Personal and Impersonal Accounts.
   (ii) Real Accounts and Nominal Accounts

2.10 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

Jain, S.P. and Narang, K.L. 2001. *Advanced Accountancy*. New Delhi: Kalyani Publishers.

Ahmed, N. 2008. *Financial Accounting*. New Delhi: Atlantic Publishers and Distributors Pvt. Ltd.

UNIT 3 SINGLE ENTRY SYSTEM

NOTES

Structure

3.0 INTRODUCTION

In unit 1 of the book earlier, we have explained that there are two systems of recording transactions in the books of a business (*i*) Single Entry System, and (*ii*) Double Entry System. The system of double entry has already been explained in the preceding chapters. As a matter of fact, the system has been followed by us so far throughout the book.

Single Entry System may be defined as any system which is not exactly the Double Entry System. In other words, Single Entry System may consist of: (*i*) Double entry in respect of certain transactions such as cash received from debtors, cash paid to creditors etc.; (*ii*) Single Entry in respect of certain transactions such as cash purchases, cash sales, expenses in current, fixed assets purchased etc.; (*iii*) No Entry in respect of certain transactions such as depreciation, bad debts etc. Thus, a business is said to be using Single Entry System if it is not following completely the principles of Double Entry System of Book-keeping. Kohler defines Single Entry System as, "A system of book-keeping in which as a rule only records of cash and of personal accounts are maintained, it is always incomplete double entry varying with the circumstances".

3.1 OBJECTIVES

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

- Understand the concept of single entry system
- Appreciate the features and limitations of single entry system
- Compute the profits as per Net Worth Method and Conversion Method
- Explain the meaning of statement of affairs method

3.2 SALIENT FEATURES

NOTES

The salient features of the Single Entry System can be put as follows:

(*i*) **Maintenance of personal accounts** Usually under this system personal accounts are maintained while real and nominal accounts are avoided. On account of this reason some accountants define it as a system where only personal accounts are maintained.

(*ii*) **Maintenance of cash book** A Cash Book is maintained, which usually mixes up both the personal transactions and the business transactions.

(*iii*) **Dependence on original vouchers** In order to collect the necessary information one has to depend on original voucher. For example, the figure of credit purchases may not be readily available, it may have to be found out on the basis of original invoices received from the suppliers. Similarly, the total figure of sales at the end of a particular period may have to be found out on the basis of the invoices which have been issued by the business from time to time.

(*iv*) **No uniformity** The system may differ from firm to firm as per their individual requirements and conveniences.

(*v*) **Suitability** The system is suitable in case of small, proprietary or partnership concerns. Limited companies can not adopt this system on account of legal requirements.

3.2.1 Disadvantages

The system suffers from several disadvantages:

(*i*) **Arithmetical accuracy cannot be checked** In case of Double Entry System of Book-keeping Trial Balance is prepared to check the arithmetical accuracy of the books of accounts. This is possible because every transaction is recorded at two places. In case of Single Entry System, this is not done. Hence, Trial Balance cannot be prepared and the arithmetical accuracy of the books of accounts cannot be checked. This increases the possibility of more frauds and misappropriations as compared to the Double Entry System of Book-keeping.

(*ii*) **True profits cannot be known** In the absence of complete information for sales, purchases and other expenses, it is not possible to draw the Profit and Loss Account. Hence, the true profit or loss made or suffered by the business cannot be known.

(*iii*) **Financial position of the business cannot be judged** In the absence of true figure of profit and correct information about the assets and liabilities of the business, the Balance Sheet cannot be drawn up to give a correct picture of the financial position of the business on a particular date.

NOTES

(*iv*) **Make planning and decision-making difficult** The system does not provide accurate figures about the performance of the business and its financial position. For example, separate figures of gross profit, net profit and sales are not available. Thus, the ratio of gross profit to sales or net profit to sales cannot be found out. Similarly in the absence of any information about the cost of goods sold, the proportion of different elements of cost of sales cannot be found out. In the absence of such information, it becomes difficult for the proprietor of the business to know the reasons of his improving or deteriorating profitability and financial position. Thus, he is not in a position to compare, plan and take sound decision for the prosperity of the business. Moreover, it may be difficult for him to find the real value of his business in the event of his deciding to sell the business.

3.3 COMPUTATION OF PROFIT

The profit (or loss) in case of a business maintaining accounts according to Single Entry System can be computed by two methods:

(*i*) Net Worth Method.

(*ii*) Conversion Method. (Conversion of Single entry into Double Entry System)

3.3.1 Net Worth Method

According to this method, the profit or loss made by the business is computed by comparing the net worth (or capital) of the business on two different dates. For example, if the capital of the business on 1.1.2010 was ₹80,000 and it is ₹90,000 on 31st December, 2010, it can be said that the business has made profit of ₹10,000 during the period.

Adjustments. Following adjustments are required for determination of the profit in case of this method.

(*i*) **Adjustment for drawings** The proprietor may withdraw money from the business for his personal use. In the absence of any such withdrawal, the capital at the end of accounting period would have been more by the amount of money withdrawn by him. Thus, the amount of drawings should be added back to the capital at the end of the accounting period to find out his true capital on that date.

(*ii*) **Adjustment for capital introduced** The proprietor may introduce further capital in the business during the course of the accounting year. This will increase the capital of the proprietor at the end of the accounting year. It is, therefore, necessary to reduce the amount of capital by the amount of capital introduced by the proprietor during the year in order to ascertain the real increase in the capital of the proprietor on account of profit earned by him during the course of the accounting year.

NOTES

Illustration 3.1. From the following information, prepare a Statement of Profit showing the amount of profit earned by '*A*' during the year 2017.

Particulars	₹
Capital as on 31.12.2017	90,000
Capital as on 1.1.2017	80,000
A's Drawings	5,000
Further capital introduced by *A*	3,000

Solution:

STATEMENT OF PROFIT
for the year 2017

Particulars	₹
Capital as on 31.12.2017	90,000
Add: Drawings	5,000
	95,000
Less: Further capital introduced by *A*	3,000
	92,000
Less: Capital as on 1.1.2017	80,000
Profit made during the year	12,000

Computation of net worth or capital On the basis of whatever has been stated in the preceding pages, it is clear that in order to determine profit or loss made during a period on the basis of net worth method, it is necessary to know the net worth or capital both in the beginning as well as at the end of the accounting period. This is done by preparing a Statement of Affairs.

Statement of Affairs is a statement giving the assets and liabilities of the business on a particular date. It is virtually the Balance Sheet of the business. However, the term Balance Sheet is used for the Statement of Assets and Liabilities in the Double Entry System of Book-keeping where balances are taken from the ledger. In case of Single Entry System, all the assets and liabilities which appear in the Statement of Affairs are not necessarily taken from the ledger accounts on account of incomplete recording of the transactions. Moreover, the term Balance Sheet is used for statement which shows the correct financial position of the business. In case of Single Entry System, it may not be possible to prepare a statement which shows the correct financial position of the business since the information is collected from different sources which may include not only the books of accounts but also other sources which may not be hundred per cent reliable. For example, estimate about drawings may have to be made on the basis of the estimated living expenses of the proprietor of the business and also other estimated payments which might have been made on his behalf.

Steps for preparing Statement of Affairs

The following steps may be taken for preparing the Statement of Affairs.

(*i*) In most cases in single entry system, a cash book is maintained. In case this has been done, the cash and the bank balances can be taken from the cash book. In the absence of a proper cash book, cash balance may have to be found out by preparing a receipts and payments account on the basis of information collected from the proprietor of the business and the statement of accounts which might have been received or sent by the proprietor from/to his debtors and creditors. Information regarding other business expenses can be collected from the salaries register of his employees, petty cash book, if any, maintained by him, etc., and the actual cash balance available with the business The balance at the bank can be verified from the bank pass book or Statement of Account from the Bank.

(*ii*) A list of sundry debtors and creditors should be prepared. This may not be difficult because in most cases, a record of personal accounts is maintained under the single entry system.

(*iii*) The value of the fixed assets like building, plant, furniture, etc., should be ascertained from vouchers or other documents available with the business. A reasonable charge for depreciation should also be made and the assets should be shown in the Statement of Affairs after charging depreciation.

(*iv*) A physical verification of the stock should be taken and the value of the stock in hand should be ascertained on the basis of the different invoices received from suppliers from time to time in respect of the goods purchased.

(*v*) The amount of outstanding expenses and the accrued income should also be determined. Last year's figures about these items may be of considerable help in this respect.

(*vi*) The excess of assets over liabilities should be found out and this will denote the net worth or the capital of the business on the date on which the Statement of Affairs has been prepared.

Difference between Balance Sheet and Statement of Affairs

Both balance sheet and statement of affairs show the financial position of a business on a particular date. However, they differ from each other in several ways:

(*i*) A balance sheet is prepared from the Trial Balance extracted on the basis of ledger accounts. While a statement of affairs is prepared from ledger accounts and several additional informations available from other sources.

(*ii*) Balance sheet is assumed to show the true financial position of the business while it may not be the case in case of statement of affairs.

(*iii*) The omissions of assets and liabilities cannot be easily traced in a statement of affairs while such omissions can be traced in a balance sheet.

(*iv*) A balance sheet is bascially prepared to show the financial position of a business on a particular date. While a statement of affairs helps in ascertaining not only the financial position but also the profit made by the business during a particular period.

(*v*) The capital account balance shown in the balance sheet is taken from the ledger. While the capital account balance in case of a statement of affaris is the excess of assets over liabilities on a particular date.

Sole-proprietary Firms

Illustration 3.2. *A* keeps his books by single entry system. His position on January 1, 2017 was as follows:

Cash at Bank ₹5,000; Cash in hand ₹1,000; Stock ₹7,000; Sundry Debtors ₹8,400; Machinery and Plant ₹6,500; Bills Receivable ₹2,600; Creditors ₹2,500; Bills Payable ₹4,000.

On December 31, 2017, his position was as follows:

Cash at Bank ₹4,300; Cash in hand ₹1,700; Stock ₹9,000; Sundry Debtors ₹6,000; Machinery and Plant ₹6,500; Bills Payable ₹3,200; Bill Receivable ₹3,200; Creditors ₹1,600. During the year *A* introduced further capital of ₹2,000 and his drawings were ₹800 per month.

Depreciate Machinery and Plant by 5% and create a Reserve for Bad and Doubtful Debts @ 5%.

From the above information, prepare a statement showing the profit or loss made by him for the year ended December 31, 2017.

Solution:

A's STATEMENT OF AFFAIRS
as on 1.1.2017

Liabilities	₹	*Assets*	₹
Creditors	2,500	Cash at Bank	5,000
Bills Payable	4,000	Cash in hand	1,000
Capital (balancing figure)	24,000	Stock	7,000
		Debtors	8,400
		Machinery and Plant	6,500
		Bills Receivable	2,600
	30,500		30,500

NOTES

A's STATEMENT OF AFFAIRS
as on 31.12.2017

Liabilities	₹	*Assets*		₹
Bills Payable	3,200	Cash at Bank		4,300
Creditors	1,600	Cash in hand		1,700
Capital (balancing figure)	25,275	Stock		9,000
		Debtors	6,000	
		Less: Provision @ 5%	300	
		Machinery and Plant	6,500	5,700
		Less: Dep. @ 5%	325	6,175
		Bills Receivable		3,200
	30,075			30,075

STATEMENT OF PROFIT
for the year ending 31.12.2017

Particulars	₹
Capital as on 31.12.2017	25,275
Add: Drawings made during 2017 (₹800×12)	9,600
	34,875
Less: Fresh capital introduced	2,000
	32,875
Less: Capital as on 1.1.2017	24,000
Profit made during 2017	8,875

Illustration 3.3. Mahesh, who keeps his books by Single Entry, has submitted returns to the Income Tax Authorities showing his income to be as follows:

	₹
Year ending December 31, 2011	7,350
Year ending December 31, 2012	7,400
Year ending December 31, 2013	7,870
Year ending December 31, 2014	13,750
Year ending December 31, 2015	12,140
Year ending December 31, 2016	9,26

The Income Tax Officer is not satisfied as to the accuracy of the accounts submitted. You are instructed to assist in establishing their correctness, and for that purpose you are supplied with the following information:

(*a*) Business liabilities and assets as 31st December, 2010 were: Debtors ₹1,450; Cash at Bank and in hand, ₹9,470; Stock, ₹5,420 (at selling price which is 25% above cost); Creditors, ₹7,320.

(*b*) Mahesh owed his brother, ₹4,000 on 31st December, 2010. On 15th February, 2013 he repaid this amount and on 1st January, 2016, he lent his brother ₹3,000.

(*c*) Mahesh owns a house which he purchased in 2016 for ₹20,000 and a car purchased in 2012 for ₹7,500. In 2015, he bought 10,000 shares in *X* Ltd. for ₹7,500.

(*d*) In 2016 ₹3,000 was stolen from his house.

NOTES

(*e*) Mahesh estimates that living expenses have been: 2011, ₹3,000; 2012, ₹4,000; 2013, ₹6,000; 2014, 2015 and 2016, ₹7,000 per annum exclusive of the amount stolen.

(*f*) On 31st December, 2017, the business Liabilities and Assets were: Creditors ₹8,400, Debtors, ₹5,920; Cash in hand and at bank, ₹19,450 and Stock ₹6,740 (at selling price which shows a gross profit of 25%).

From the information submitted, prepare a statement showing whether or not the income declared by Mahesh is correct.

Solution:

STATEMENT OF AFFAIRS

as on 31.12.2016

Liabilities	₹	*Assets*		₹
Creditors	8,400	Cash in hand and at Bank		19,450
Capital (balancing figure)	22,025	Debtors		5,920
		Stock	6,740	
		Less: Profit	1,685*	5,055
	30,425			30,425

* The percentage of gross profit to sales is 25%. The amount of profit involved in the stock of ₹6,740 (at selling price) has been computed as follows:

$$\frac{6{,}704 \times 25}{100} = 1{,}685$$

STATEMENT OF AFFAIRS

as on 31.12.2010

Liabilities	₹	*Assets*		₹
Creditors	7,320	Cash at Bank and in hand		9,470
Capital (balancing figure)	7,936	Debtors		1,450
		Stock	5,420**	
		Less: Profit 20%	1,084	4,336
	15,256			15,256

**The stock is appearing at selling price which includes a profit of 25% on cost. In other words, if cost is ₹100, the selling price is ₹125. The amount of profit involved in the stock or ₹5,420 has been computed as follows:

$$\frac{5{,}420 \times 25}{125} = 1{,}084 \text{ ₹}1{,}084$$

STATEMENT OF PROFIT

for the period from 1.1.2011 to 31.12.2016

Particulars		₹
Capital as on 31.12.2016 as per Statement of Affairs		22,025
Add: Living expenses during this period:		
20011	3,000	
20012	4,000	
20013	6,000	
20014 to 2016	21,000	34,000
		56,025
Less: Capital as on 31.12.2010 as per Statement of Affairs		7,936
Profit as per Books during the period:		48,089
Add: Undisclosed incomes:*		
(*a*) Repayment of Brother's loan	4,000	

NOTES

Particulars		₹
(*b*) Money lent to Brother	3,000	
(*c*) Purchase of car	7,500	
(*d*) Purchase of shares	7,500	
(*e*) Amount stolen from the house	3,000	25,000
		73,089
Actual Income during the period		
Less: Declared Income		
2011	7,350	
2012	7,400	
2013	7,870	
2014	13,750	
2015	12,140	
2016	9,260	57,770
Excess of Actual Income over Declared Income		15,319

*Any purchase of property or lending of money or repayment of loan etc. during the period 1.1.2011 to 31.12.2016 will be taken as additional income of Mahesh, since only the living expenses have been so far added to the capital at the end of 2016. The house was purchased by Mahesh in 2006. It does not fall within the period from 1.1.2011 to 31.12.2016 and, therefore, it has been excluded. However, repayment of the brother's loan, lending money to his brother, purchase of shares, purchase of car and theft of money from his house have all been added in order to find out his real income.

Partnership Firms

In case of a partnership firm, the balances in the capital accounts of all the partners will have to be considered for ascertainment of the profit made by the business. However, where partners have a fixed capital system (*i.e.,* where current accounts are maintained), the balances in the current accounts should be considered while preparing Statement of Profit. Capital Accounts of the partners should be adjusted for any fresh capital introduced or withdrawn by the partners before ascertaining the combined closing balance of the current accounts.

Illustration 3.4. *A, B* and *C* were in partnership, and towards the end of 2017 most of their books and records were destroyed in a fire. The Balance Sheet as on 31st December, 2016 was as under:

Liabilities		₹	Assets	₹
Creditors		5,500	Cash	2,400
Capitals:			Debtors	3,600
A	4,500		Stock	6,500
B	3,000		Machinery	1,440
C	1,500	9,000	Fixture and Fittings	600
Current Accounts:			Advance Payments	35
A	145		Current Account:	
B	100	245	*C*	170
		14,745		14,745

The partners' drawings during 2017 have been proved at *A*: ₹1,400; *B:* ₹1,000 and *C:* ₹650. *A* introduced ₹1,500 as additional capital on July 1, 2017. On 31st December, 2017 the cash was ₹3,200, Debtors ₹4,025, Stock ₹5,900, Advanced Payments ₹25 and Creditors ₹4,540. Machinery is to be depreciated by 10% per annum and Fixtures and Fittings as 7½%. 5% interest is to be allowed on capitals. No interest is to be charged on drawings. The partners share profits in the proportions of 3 : 2 : 1.

You are required to prepare a statement, showing the net trading profit for the year 2017 and the division of the same between the partners, together with the Balance Sheet as on 31st December, 2017.

Solution:

A, B* and *C
STATEMENT OF AFFAIRS
as on 31st December, 2017

Liabilities		₹	*Assets*		₹
Sundry Creditors		4,540	Cash		3,200
Capital Accounts: (Fixed)			Sundry Debtors		4,025
A	6,000		Stock		5,900
B	3,000		Advance Payments		25
C	1,500	10,500	Machinery	1,440	
			Less: Depreciation	144	1,296
			Fixtures & Fittings	600	
			Less: Depreciation	45	555
			Combined Current Accounts		
			(balancing figure)		39
		15,040			15,040

STATEMENT OF PROFIT & LOSS

Particulars	₹	₹
Combined Current Accounts as on 31.12.2017		(Dr.) 39
Add: Drawings: *A*	1,400	
B	1,000	
C	650	3,050
		3,011
Less: Combined Current Accounts as on 31.12.2016:		
A	145	
B	100	
C	(Dr.) 170	75
Profit subject to interest on capitals		2,936
Interest on Capital:		
A (225 + 38)	263	
B	150	
C	75	488
Profit		2,448
Division of Profit		
A		1,224
B		816
C		408

NOTES

CURRENT ACCOUNTS

Particulars	*A* ₹	*B* ₹	*C* ₹	*Particulars*	*A* ₹	*B* ₹	*C* ₹
To Balance b/d			170	By Balance b/d	145	100	
To Drawing	1,400	1,000	650	By Interest on Capitals	263	150	75
To Balance c/d	232	66		By Profit	1,224	816	408
				By Balance c/d			337
	1,632	1,066	820		1,632	1,066	820

A, B, and C
BALANCE SHEET
as on 31st December, 2017

Liabilities		₹	*Assets*		₹
Sundry Creditors		4,540	Cash		3,200
Capital Accounts (Fixed)			Sundry Debtors		4,025
A	6,000		Stock		5,900
B	3,000		Advance Payments		25
C	1,500	10,500	Machinery:	1,440	
Current Accounts			*Less:* Depreciation	144	1,296
A	232		Fixtures & Fittings	600	
B	66	298	*Less:* Depreciation	45	555
			C's Current Account		337
		15,328			15,238

3.3.2 Conversion of Single Entry into Double Entry System

The Net Worth Method explained in the preceding pages does not provide a clear picture of the operational results of a business. It does not give information about sales, purchases, gross profit, operating expenses etc. of the business. As a result, a meaningful analysis of the financial statements cannot be done nor effective steps can be taken to improve the financial position of business. It will, therefore, be better to collect all such information from the books of accounts, and other sources which are necessary for preparing Trial Balance of the business. This is done by preparing a Total Debtors Account, a Total Creditors Account, a Bills Receivable Account, a Bills Payable Account and Receipts and Payments Account etc., on the basis of double entry. Account relating to different expenses, incomes, fixed assets and fixed liabilities and outstanding are also prepared with the help of Receipts & Payments Account and additional information available. Thus, the closing balances of different accounts are found out and a Trial Balance prepared. Final accounts can then be prepared in the usual way. Such a method of collecting information as per the requirements of the double entry system of book-keeping, is termed as Conversion Method.

NOTES

Check Your Progress

1. What is a net worth method?
2. How is the computation of net worth or capital done?
3. What is the main purpose of balance sheet and statement of affairs?

3.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. According to this method, the profit or loss made by the business is computed by comparing the net worth (or capital) of the business on two different dates.
2. The computation of net worth or capital is done by preparing a statement of affairs.
3. Both balance sheet and statement of affairs show the financial position of a business on a particular date.

3.5 SUMMARY

- Single Entry System may be defined as any system which is not exactly the Double Entry System. In other words, Single Entry System may consist of: (i) Double entry in respect of certain transactions such as cash received from debtors, cash paid to creditors etc.; (ii) Single Entry in respect of certain transactions such as cash purchases, cash sales, expenses in current, fixed assets purchased etc.; (iii) No Entry in respect of certain transactions such as depreciation, bad debts, etc.
- In case of Double Entry System of Book-keeping Trial Balance is prepared to check the arithmetical accuracy of the books of accounts. This is possible because every transaction is recorded at two places. In case of Single Entry System, this is not done.
- The profit (or loss) in case of a business maintaining accounts according to Single Entry System can be computed by two methods: (i) Net Worth Method. (ii) Conversion Method.
- On the basis of whatever has been stated in the preceding pages, it is clear that in order to determine profit or loss made during a period on the basis of net worth method, it is necessary to know the net worth or capital both in the beginning as well as at the end of the accounting period. This is done by preparing a Statement of Affairs.
- Both balance sheet and statement of affairs show the financial position of a business on a particular date. However, they differ from each other in several ways.

NOTES

- In case of a partnership firm, the balances in the capital accounts of all the partners will have to be considered for ascertainment of the profit made by the business. However, where partners have a fixed capital system (i.e., where current accounts are maintained), the balances in the current accounts should be considered while preparing Statement of Profit.
- The Net Worth Method explained in the preceding pages does not provide a clear picture of the operational results of a business. It does not give information about sales, purchases, gross profit, operating expenses etc. of the business. As a result, a meaningful analysis of the financial statements cannot be done nor effective steps can be taken to improve the financial position of business.

3.6 KEY WORDS

- **Net Worth:** It is the same as net assets. It refers to the excess of the book value of assets (other than fictitious assets) of an enterprise over its liabilities.
- **Single Entry System:** An incomplete double entry system varying with the circumstances.

3.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State whether each of the following statements is True or False:
   (i) Joint Stock Companies can also adopt Single Entry System.
   (ii) Trial Balance can be prepared in case the books are maintained according to Single Entry System.
   (iii) In order to determine the profit according to Net Worth Method of single entry, the profit and loss account is prepared.
   (iv) The Statement of Affairs shows the financial position of the business on a particular date in case of Single Entry System.
2. Choose the most appropriate answer:
   (i) In case of net worth method of single entry, net profit is ascertained by
      (a) preparing a Trading and Profit and Loss Account.
      (b) comparing the capital in the beginning and capital at the end of the accounting period.
      (c) adopting any other method.

(ii) The capital in the beginning of the accounting year is ascertained by preparing:

   (a) Cash account. (b) Opening Statement of Affairs.

   (c) Total Creditors Account.

Long Answer Questions

1. Explain the Single Entry System. State its disadvantages and explain how the profit can be determined under this system.
2. Explain in detail the steps to convert a set of books kept under Single Entry System into Double Entry System.

3.8 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

Jain, S.P. and Narang, K.L. 2001. *Advanced Accountancy*. New Delhi: Kalyani Publishers.

Ahmed, N. 2008. *Financial Accounting*. New Delhi: Atlantic Publishers and Distributors Pvt. Ltd.

NOTES

UNIT 4 PREPARATION OF PROFIT AND LOSS AND BALANCE SHEET UNDER SINGLE ENTRY SYSTEM

Structure

4.0 INTRODUCTION

Net worth method is also called the statement of affairs method or capital comparison method. According to this method, profit or loss of the business is determined by making a comparison between the capitals of two dates of a period. If there are other capital related items such as drawing, additional capital, interest on capital etc. are to be adjusted to ascertain the amount of profit or loss.

4.1 OBJECTIVES

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

- Analyse the steps required in the preparation of final accounts
- Describe the categories of ascertaining of stocks
- Discuss the process of ascertaining other balances

4.2 PREPARATION OF FINAL ACCOUNTS

Final accounts can be prepared by collecting information as per the requirements of the double entry system of book-keeping. It is called the conversion method.

In practice usually Abridged Conversion Method is followed. Under this method, normal accounts are not opened in the ledger, nor a trial balance is prepared. Only such information is collected which is required for preparing the Trading and Profit & Loss Account, and Balance Sheet of the business.

The following steps will be taken for preparing final accounts according to this method:

1. **Ascertainment of sales:** Sales may be of two types (*i*) Credit Sales, and (*ii*) Cash Sales. Credit Sales should be found out by preparing a Total Debtors Account while cash sales should be found out from the Cash Book.

Illustration 4.1. From the following information, find out the Credit Sales:

	₹		₹
Balance of Debtors on 1.1.2017	12,000	Bills Receivable from customers	17,000
Returns Inward	5,000	Bad Debts	1,500
Cash received from customers	45,000	Bills Receivable Dishonoured	3,500
Discount allowed to them	3,000	Debtors on 31.12.2017	10,000

Solution:

TOTAL DEBTORS ACCOUNT
(or Sundry Debtors Account)

Particulars	₹	*Particulars*	₹
To Balance b/d	12,000	By Returns Inward	5,000
To Bill Receivable dishonoured	3,500	By Cash	45,000
To Credit Sales		By Discount	3,000
(balancing figure)	66,000	By Bills Receivable	17,000
		By Bad Debts	1,500
		By Balance c/d	10,000
	81,500		81,500

The amount of Cash Sales may be given in the Cash Book. However, its amount may have to be ascertained by preparing a Receipts and Payments Account in case complete Cash Book has not been given.

Illustration 4.2. From the following cash transactions ascertain the amount of Cash Sales:

	₹		₹
Cash Balance as on 1.1.2017	5,000	Payment made to Creditors	10,000
Bank Balance as on 1.1.2017	10,000	Cash Purchases	20,000
Cash collected from Debtors	20,000	Cash Balance as on 31.12.2017	10,000
Other Income	5,000	Bank Balance as on 31.12.2017	15,000

Solution:

RECEIPTS AND PAYMENTS ACCOUNT
for the year ending 31st December, 2017

Particulars	₹	*Particulars*	₹
To Balance:		By Creditors	10,000
Cash in Hand	5,000	By Purchases	20,000
To Cash at Bank	10,000	By Balance:	
To Debtors	20,000	Cash in Hand	10,000
To Other Incomes	5,000	Balance at Bank	15,000
To Cash Sales (balancing figure)	15,000		
	55,000		55,000

In the above illustration, cash receipts (including opening cash and bank balances) without taking into account the amount of cash sales amounts to ₹40,000, while cash payments (including closing cash and bank balances) amount to ₹55,000. This means ₹15,000 must have been received from somewhere. There can be three important sources: (*i*) Cash Sales, (*ii*) Collections from debtors, and (*iii*) Introduction of further capital by the proprietor. Since the amount of cash collected from debtors has already been given the choice falls between introduction of further capital by the proprietor and the sales. In the absence of any other information, it will be proper to presume that cash ₹15,000 is on account of cash sales.

On the same basis, the amount of cash collected from debtors can be found out. For example, if in the above illustration, the cash sales are given as ₹20,000, and other figures remain the same, the amount of cash collected from debtors can be taken as ₹15,000.

2. **Ascertainment of purchases:** The purchases may be of two types (*i*) Credit purchases, and (*ii*) Cash purchases. The amount of credit purchases can be ascertained by preparing a Total Creditors Account.

Illustration 4.3. From the following information, find out the Credit Purchases for the year 2010.

	₹		₹
Balance of Creditors on 1.1.2017	7,600	Returns Outward	2,400
Cash paid to Creditors	20,000	Bills accepted	4,600
Discount allowed by them	500	Creditors on 31.12.2017	9,500

Solution:

TOTAL CREDITORS ACCOUNT

Particulars	₹	*Particulars*	₹
To Cash	20,000	By Balance b/d	7,600
To Discount	500	By Credit Purchases	
To Returns Outward	2,400	(balancing figure)	29,400
To Bills Payable A/c	4,600		
To Balance c/d	9,500		
	37,000		37,000

The amount of cash purchases can be ascertained from the Cash Book. In case complete Cash Book has not been given, the amount of cash purchases can be ascertained by preparing a Receipts and Payments Account.

Illustration 4.4. From the following cash transactions, ascertain the amount of cash purchases.

Particulars	₹	*Particulars*	₹
Balance as on 1.1.2017 Cash	10,000	Cash paid to Creditors	40,000
Bank	20,000	Balances as on 31.12.2017	
Cash receipts from debtors	30,000	Cash	10,000
Cash sales	10,000	Bank	10,000

NOTES

Solution:

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31st December, 2017

Particulars	₹	*Particulars*	₹
To Balance b/d:		By Creditors	40,000
To Cash in Hand	10,000	By Cash Purchases	
To Cash at Bank	20,000	(balancing figure)	10,000
To Debtors	30,000	By Balance c/d:	
To Cash Sales	10,000	Cash in Hand	10,000
		Cash at Bank	10,000
	70,000		70,000

In the above illustration, total cash receipts including opening balances amount to ₹70,000 while total cash payments including closing balances amount to ₹60,000. It means ₹10,000 must have been paid for some item. There can be three possible alternatives.

(*i*) Payments to Creditors, (*ii*) Drawing by the proprietor, and (*iii*) Cash Purchases. The amount paid to creditors is already given in the question. The choice is now between the drawings made by the proprietor and the cash purchases. In the absence of any other information, it will be better to presume this as the amount of cash purchases.

In case, in the above illustration, the amount of cash purchases had been given as ₹40,000, the balancing figure could have been taken as the amount paid to the creditors as ₹10,000.

3. **Ascertainment of stocks:** Stocks may be classified into two categories: (*i*) Opening Stock, and (*ii*) Closing Stock. The amount of Opening Stock or Closing Stock can be ascertained by preparing a Memorandum Trading Account.

Illustration 4.5. From the following particulars, find out the amount of Opening Stock.

	₹		₹
Purchases	20,000	Rates of Gross Profit on Sales	25%
Sales	30,000	Closing Stock	10,000

Solution:

MEMORANDUM TRADING ACCOUNT

Particulars	₹	*Particulars*	₹
To Opening Stock		By Sales	30,000
(balancing figure)	14,000	By Closing Stock	10,000
To Purchases	20,000		
To Gross Profit (20% of Sales)	6,000		
	40,000		40,000

Alternatively: Opening Stock = Cost of Sales + Closing Stock – Purchases
= 24,000 + 10,000 – 20,000 = ₹14,000

Illustration 4.6. From the following figures, calculate the amount of Closing Stock.

	₹		₹
Opening Stock	10,000	Sales	40,000
Purchases	30,000	Gross Profit on Sales	20%

Solution:

NOTES

MEMORANDUM TRADING ACCOUNT

Particulars	₹	*Particulars*	₹
To Opening Stock	10,000	By Sales	40,000
To Purchases	30,000	By Closing Stock	
To Gross Profit (20% of sales)	8,000	(balancing figure)	8,000
	48,000		48,000

Alternatively: Closing Stock= Opening Stock + Purchases – Cost of Sales
= 10,000 + 30,000 – 32,000 = 8,000

4. **Ascertainment of cash and bank balances** The amount of Cash in Hand or Cash at Bank can be ascertained by preparing a Receipts and Payments Account in case Cash Book completed in all respects has not been given.

Illustration 4.7. From the following figures, ascertain the amount of cash in hand as on 31.12.2011:

	₹		₹
Cash in hand as on 1.1.2017	5,000	Total Cash Payments	35,000
Cash at Bank on 1.1.2017	10,000	Cash at bank 31.12.2017	5,000
Total Cash Receipts	30,000		

Solution:

RECEIPTS AND PAYMENTS ACCOUNT

Particulars		₹	*Particulars*	₹
To Balance on 1.1.2017			By Cash Payments	35,000
Cash in Hand	5,000		By Balance:	
Cash at Bank	10,000	15,000	Cash in Hand	
To Cash Receipts		30,000	(balancing figure)	5,000
			Cash at Bank	5,000
		45,000		45,000

Illustration 4.8. From the following figures, calculate the amount of Cash at Bank on 1.1.2011

	₹		₹
Cash in hand 1.1.2017	5,000	Cash in Hand on 31.12.2017	8,000
Total Cash Receipts	10,000	Cash at Bank on 31.12.2017	2,000
Total Cash Payments	15,000		

Solution:

RECEIPTS AND PAYMENTS ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance on 1.1.2017		By Cash Payments	15,000
Cash in Hand	5,000	By Balance on 31.12.2017	
Cash at Bank (balancing figure)	10,000	Cash in Hand	8,000
To Cash Receipts	10,000	Cash at Bank	2,000
	25,000		25,000

On the same basis Cash at Bank at the end of the accounting year or cash in hand in the beginning of the accounting year can be ascertained.

5. **Ascertainment of total debtor's balances** The balance in the Debtors Account in the beginning of accounting year or at the end of the accounting year can be ascertained by preparing a Total Debtors Account.

Illustration 4.9. From the following data, ascertain the amount of Debtors as on 1.1.2017

	₹		₹
Sales during 2017 (including cash sales of ₹10,000)	40,000	Bad Debts	3,000
		Returns Inward	5,000
Bills of Exchange received from the customers during 2017	10,000	Bad Debts previously written off, now recovered	2,000
Cash received from debtors	30,000	Bills Receivable dishonoured	5,000
Discount allowed to debtors	5,000	Balance of Debtors on 31.12.2017	15,000

Solution:

TOTAL DEBTORS ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance b/d (balancing figure)	33,000	By Bills Receivable	10,000
To Credit Sales	30,000	By Cash	30,000
To Bills Receivable dishonoured	5,000	By Discount	5,000
		By Bad Debts	3,000
		By Returns Inward	5,000
		By Balance c/d	15,000
	68,000		68,000

On the same basis the Closing Balance in the Debtors Account can be ascertained in case other information have been given.

6. **Ascertainment of total creditors' balances** The balance in the Total Creditors Account in the beginning or at the end of the accounting year can be ascertained by preparing a Total Creditors Account.

Illustration 4.10. From the following date, ascertain the amount of creditors as on 31.12.2017.

	₹		₹
Creditors as on 1.1.2017	10,000	Bills Payable issued to creditors	5,000
Cash paid to creditors	20,000	Returns Outward	5,000
Purchases (including credit purchases of ₹25,000)	35,000	Discount allowed by creditors	1,000

Solution:

TOTAL CREDITORS ACCOUNT

Particulars	₹	*Particulars*	₹
To Cash	20,000	By Balance b/d	10,000
To Bills Payable	5,000	By Credit Purchases	25,000
To Returns Outward	5,000		
To Discount	1,000		
To Balance c/d (balancing figure)	4,000		
	35,000		35,000

NOTES

On the same basis the Opening Balance in the Creditors Account can be ascertained.

7. **Ascertainment of bills receivable balance** The balance of bills receivable at the beginning or at the end of the accounting year can be ascertained by preparing a Bills Receivable Account.

Illustration 4.11. From the following data, calculate the amount of Bills Receivable as on 31.12.2017.

	₹		₹
Bills Receivable as on 1.1.2017	10,000	Cash received on account of bills receivable	5,000
Bills Receivable received during the year	30,000	Bills Receivable dishonoured	5,000
Bills Receivable discounted from the bankers	10,000	Bills Receivable endorsed in favour of creditors	5,000

Solution:

BILLS RECEIVABLE ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance b/d	10,000	By Bank and Discount (Bills discounted)	10,000
To Sundry Debtors (Bills receivable received)	30,000	By Cash	5,000
		By Sundry Debtors	5,000
		By Creditors	5,000
		By Balance c/d (balancing figure)	15,000
	40,000		40,000

On the same basis, the balance in the beginning of the accounting year in the Bills Receivable Account can be ascertained if other details are given.

8. **Ascertainment of bills payable balance** The balance of the Bills Payable Account at the beginning or at the end of the accounting year can be ascertained by preparing a Bills Payable Account.

Illustration 4.12. Ascertain the amount of bills payable as on 1.1.2017.

	₹		₹
Bills payable issued in favour of creditors during 2017	30,000	Bills payable dishonoured during the year	5,000
Bills payable paid during the year	20,000	Bills payable on 31.12.2017	10,000

Solution:

BILLS PAYABLE ACCOUNT

Particulars	₹	*Particulars*	₹
To Cash	20,000	By Balance b/d (balancing figure)	5,000
To Sundry Creditors (Bills payable dishonoured)	5,000	By Sundry Creditors (Bills payable issued)	30,000
To Balance c/d	10,000		
	35,000		35,000

9. **Ascertainment of opening capital** The amount of capital in beginning of the accounting year can be ascertained by preparing a Statement of Affairs which may be called the Balance Sheet of the business in case of Conversion Method.

Illustration 4.13. From the following details ascertain *A*'s Capital as on 1.1.2017.

	₹		₹
Cash in Hand	5,000	Plant	20,000
Cash at Bank	10,000	Building	30,000
Sundry Debtors	20,000	Sundry Creditors	15,000
Stock	10,000	Bills Payable	5,000

Solution:

BALANCE SHEET

as on 1.1.2017

Liabilities	*Amt.* (₹)	*Assets*	*Amt.* (₹)
Bills Payable	5,000	Cash in Hand	5,000
Sundry Creditors	15,000	Cash at Bank	10,000
Capital (balancing figure)	75,000	Sundry Debtors	20,000
		Stock	10,000
		Plant	20,000
		Building	30,000
	95,000		95,000

10. **Ascertainment of other balances** The balances of some other assets such as Land, Building, Plant and Machinery, Furniture, etc., can be ascertained by taking into account the following:

(*i*) Balance in the beginning of the accounting year as shown by last year's Balance Sheet.

(*ii*) Any purchase or sale of the asset as shown by the Cash Book.

(*iii*) Depreciation on the basis of additional information given.

Illustration 4.14. Ascertain the Balance in the Plant Account as on 31.12.2017 on the basis of the following information:

	₹		₹
Plant as on 1.1.2017 (at original cost)	10,000	Provision Depreciation on Plant on 1.1.2017	2,000
Purchase of Plant during 2017	20,000	Book Value of the Plant sold	4,000
Sale of Plant during 2017 (original cost ₹5,000)	2,000		

Solution:

PLANT ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance	10,000	By Plant Disposal A/c	5,000
To Bank (purchase of plant)	20,000	By Balance c/d	25,000
	30,000		30,000

NOTES

PROVISION FOR DEPRECIATION ON PLANT

Particulars	₹	Particulars	₹
To Plant Disposal Account		By Balance b/d	2,000
(depreciation on plant sold)	1,000	By *P* & *L* Account	
To Balance c/d	3,500	(depreciation for the year on	
		₹25,000 at the rate of 10%)	2,500
	4,500		4,500

PLANT DISPOSAL ACCOUNT

Particulars	₹	Particulars	₹
To Plant Account	5,000	By Provision for Depreciation	
		on Plant Account	1,000
		By Bank (sale proceeds)	2,000
		By *P* & *L* Account	
		(loss on sale of plant)	2,000
	5,000		5,000

The comprehensive illustrations given in the following pages will make clear the preparation of Final Accounts under Single Entry System in case Conversion Method is followed by the business.

Tutorial Note. It will be advisable for the students to prepare Trading and Profit and Loss Account and Balance Sheet simultaneously. This will help them in finding out the missing information. They should put whatever information has been given in the question in the Final Accounts and then trace the rest of the information required by them for preparing Final Accounts. For example, if Cash Sales have been given, the students should put the amount on the credit side of the Trading Account in the inner column. Since information regarding Total Sales will be needed for Trading Account, the students should prepare Total Debtor Account. The Working Notes should invariably be given.

Illustration 4.15. Suneel commenced business as a cloth merchant on 1.1.2017, with a capital of ₹10,000. On the same day, he purchased furniture and fittings for cash ₹3,000. From the following particulars obtained from his books kept by single entry, you are asked to prepare a Trading and Profit and Loss Account for the year ending 31st December, 2017 and a Balance Sheet as on the date.

Sales (inclusive of cash ₹7,000)	₹17,000
Purchases (inclusive of cash ₹4,000)	15,000
Suneel's drawings	1,200
Salaries to staff	2,000
Bad Debts written off	500
Business expenses	700

Suneel took cloth worth ₹500 from the shop for private use and paid ₹200 to his son, but omitted to record these transactions in his books. On

31st December, 2017, his sundry debtors were ₹5,200 and sundry creditors ₹3,600. Stock in hand on 31st December, 2017, was ₹6,500.

Solution:

NOTES

SUNEEL'S TRADING AND PROFIT & LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	*Particulars*	₹
To Purchases	15,000		By Sales	17,000
Less: Drawings	500	14,500	By Closing Stock	6,500
To Gross Profit c/d		9,000		
		23,500		23,500
To Salaries		2,000	By Gross Profit b/d	9,000
To Bad Debts		500		
To Business Expenses		700		
To Net Profit		5,800		
		9,000		9,000

SUNEEL'S BALANCE SHEET

as on 31.12.2017

Particulars		₹	*Particulars*	₹
Sundry Creditors		3,600	Cash Balance	2,800
Capital	10,000		Sundry Debtors	5,200
Less: Drawings	1,900		Closing Stock	6,500
	8,100		Furniture & Fittings	3,000
Add: Net Profit	5,800	13,900		
		17,500		17,500

Working Notes:

1. RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31.12.2017

Particulars	₹	*Particulars*	₹
To Capital A/c	10,000	By Furniture	3,000
To Cash Sales	7,000	By Cash Purchases	4,000
To Sundry Debtors (Note 2)	4,300	By Drawing (1,200+200)	1,400
		By Salaries	2,000
		By Business Expenses	700
		By Sundry Creditors (Note 3)	7,400
		By Balance c/d	2,800
	21,300		21,300

2. SUNDRY DEBTORS ACCOUNT

Particulars	₹	*Particulars*	₹
To Credit Sales	10,000	By Cash (balancing figure)	4,300
		By Bad Debts	500
		By Balance c/d	5,200
	10,000		10,000

NOTES

3. SUNDRY CREDITORS ACCOUNT

Particulars	₹	*Particulars*	₹
To Cash (balancing figure)	7,400	By Credit Purchases	11,000
To Balance c/d	3,600		
	11,000		11,000

4. The Money given by Suneel to his son and cloth taken by him from the business have been taken as his drawings. The value of cloth taken has been deducted from purchases.

Illustration 4.16. The following balances were disclosed by the books of Anil.

	31.12.2016	*31.12.2017*
	₹	₹
Cash at Bank	3,000	19,100
Cash in Hand	400	850
Stock-in-trade	22,000	25,000
Sundry Debtors	?	35,000
Sundry Creditors	23,400	18,500
Fixtures and Fittings	2,000	
Office Car	1,000	

The Cash Book analysis showed the following figures amongst others:

	₹		₹
Receipts from Customers	1,35,000	Motor Upkeep	1,350
Discounts allowed to them	1,400	Printing & Stationery	800
Further capital introduced on 1.7.2017	2,000	Drawings	6,000
Salaries up to 31.11.2017	11,000	Payments to Trade creditors	1,12,000
Office rent to 30.11.2017	2,200		
Advertising	900	Discounts allowed by them	1,200
General Expenses	600	Travelling Expenses	1,000

No ready figures are available for total sales but Anil maintains a steady gross profit rate of 25% on sales.

There were bills outstanding for petrol ₹25, Advertising ₹75, and Printing ₹45. Provide 5% on debtors for doubtful debts and 2½% on creditors for discounts. The motor car fixtures are to be depreciated by 20% and 5% respectively. 5% interest is to be allowed on capital.

Prepare Anil's Trading and Profit and Loss Account for 2017 and his Balance Sheet on 31.12.2017.

NOTES

Solution:

Mr. Anil

TRADING AND PROFIT & LOSS ACCOUNT

for the year ending 31.12.2017

Particulars		₹	*Particulars*		₹
To Stock		22,000	By Sales: Cash	16,000	
To Purchases		1,08,300	Credit	1,24,400	1,40,400
To Gross Profit c/d		35,100	By Stock		25,000
		1,65,400			1,65,400
To Discount		1,400	By Gross Profit b/d		35,100
To Salaries	11,000		By Discount		1,200
Add: Outstanding	1,000	12,000	By Reserve for discount on		
To Office Rent	2,200		sundry creditors		462
Add: Outstanding	200	2,400			
To Advertising	900				
Add: Outstanding	75	975			
To General Expenses		600			
To Motor Upkeep (including					
outstanding petrol bill)		1,375			
To Printing & Stationery	800				
Add: Outstanding	45	845			
To Travelling Expenses		1,000			
To Provision for bad and					
doubtful debts		1,750			
To Depreciation:					
Motor Car	200				
Fixtures	100	300			
To Interest on Capital		2,650			
To Net Profit transferred to					
Capital Account		11,467			
		36,762			36,762

Mr. Anil

BALANCE SHEET

as on 31.12.2017

Particulars		₹	*Particulars*		₹
Capital	52,000		Cash at Bank		19,100
Add: Addition	2,000		Cash in Hand		850
Interest on Capital	2,650		Sundry Debtors	35,000	
Net Profit for the year	11,467		*Less:* Provision	1,750	33,250
	68,117		Stock		25,000
Less: Drawings	6,600	61,517	Fixtures and Fittings	2,000	
Petrol Outstanding		25	*Less:* Depreciation	100	1,900
Advertising Outstanding		75	Office Car	1,000	
Printing Outstanding		45	*Less:* Depreciation	200	800
Salaries Outstanding		1,000			
Rent Outstanding		200			

Sundry Creditors	18,500				
Less: Reserve for discount	462	18,038			
		80,900			80,900

NOTES

Working Notes:

1. **Mr. Anil**

RECEIPTS AND PAYMENTS ACCOUNT

Particulars		₹	*Particulars*		₹
To Balance b/d			By Salaries		11,000
Bank	3,000		By Rent		2,200
Cash	400	3,400	By Advertising		900
To Sundry Debtors		1,35,000	By General Expenses		600
To Anil—Capital Introduced		2,000	By Motor Upkeep		1,350
To Cash Sales			By Printing & Stationery		800
(balancing figure)		16,000	By Drawings		6,600
			By Trade Creditors		1,12,000
			By Travelling Expenses		1,000
			By Balance c/d		
			Bank	19,100	
			Cash	850	19,950
		1,56,400			1,56,400

2. **Mr. Anil**

BALANCE SHEET

as on 31.12.2016

Particulars	₹	*Particulars*	₹
Sundry Creditors	23,400	Cash at Bank	3,000
Capital (balancing figure)	52,000	Cash in Hand	400
		Stock-in-trade	22,000
		Sundry Debtors	47,000
		Fixtures and Fittings	2,000
		Office Car	1,000
	75,400		75,400

3. SUNDRY DEBTORS ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance b/d		By Cash	1,35,000
(balancing figure)	47,000	By Discount	1,400
To Credit Sales		By Balance c/d	35,000
(Total sales *less* Cash sales)	1,24,400		
	1,71,400		1,71,400

SUNDRY CREDITORS ACCOUNT

Particulars	₹	*Particulars*	₹
To Cash	1,12,000	By Balance b/d	23,400
To Discount	1,200	By Purchases (balancing figure)	1,08,300
To Balance c/d	18,500		
	1,31,700		1,31,700

NOTES

4. Sales

	₹
Opening Stock	22,000
Purchases	1,08,300
	1,30,300
Less: Closing Stock	25,000
Cost of goods sold	1,05,300
Add: Profit (1/3 of cost)	35,100
Total Sales	1,14,400

Illustration 4.17. Prepare a Trading A/c, Profit & Loss A/c for the year ended 31st December, 2017 and Balance Sheet as at that date from the following information available from the books of a Trader.

	31.12.2016	*31.12.2016*
	₹	₹
1. Liabilities & Assets		
Bank Balance	20,000	9,400
Cash in hand	3,000	2,000
Prepaid Expenses	5,000	7,000
Stock	70,000	60,000
Debtors for sales	2,30,000	?
Bills Receivable	—	?
Furniture at written down value	70,000	82,000
Creditors for purchases	2,20,000	2,60,000
Outstanding Liabilities	30,000	15,000
2. Receipts and Payments during 2017		
Collection from debtors (after allowing 2½% discount		5,85,000
Proprietor's Drawings		50,000
Capital introduced by proprietor		95,150
Purchase of Furniture at the middle of the year		20,000
4% Govt. Securities purchased at 96% on 1.7.2017		96,000
Expenses		2,00,000
Sale of Scrap		5,000
Payment to Creditors (after receiving 2% discount)		3,92,000
Proceeds of Bills Receivable discounted at 2%		61,250

3. Sales are made so as to realise $33\frac{1}{3}$% profit on sale proceeds.
4. Goods worth ₹5,000 were taken by the proprietor.
5. During the year Bills Receivable worth ₹1,50,000 were drawn on Debtors. Of these, bills amounting to ₹30,000 were endorsed in favour of the creditors. Out of this later amount, a bill for ₹5,000 was dishonoured by the debtor.
6. Sales and Purchases are made on credit.

Solution:

TRADING AND PROFIT & LOSS ACCOUNT

for the year ending 31st December, 2017

NOTES

Particulars		₹	*Particulars*	₹
To Opening Stock		70,000	By Sales	7,05,000
To Purchases	4,65,000		By Closing Stock	60,000
Less: Drawings by Proprietor	5,000	4,60,000		
To Gross Profit c/d		2,35,000		
		7,65,000		7,65,000
To Expenses		1,83,000	By Gross Profit b/d	2,35,000
To Depreciation		8,000	By Interest on Securities	2,000
To Discount on Debtors		15,000	By Discount	8,000
To Discount on Bills Receivable		1,250	By Sale of Scrap	5,000
To Net Profit		42,750		
		2,50,000		2,50,000

BALANCE SHEET

as on 31st December, 2017

Particulars		₹	*Particulars*		₹
Capital:			*Fixed Assets*:		
Opening	1,48,000		Furniture	90,000	
Add: Introduced during the year	95,150		*Less:* Depreciation	8,000	82,000
Profit for the year	42,750		Investment		
	2,85,900		4% Govt. Securities		
Less: Drawings	55,000	2,30,900	(Nominal Value ₹1,00,000)		96,000
			Current Assets, Loans and Advances:		
Sundry Creditors		2,60,000			
Outstanding Expenses		15,000	Stock in Trade		60,000
			Sundry Debtors		1,90,000
			Bills Receivable		57,500
			Interest Accrued		2,000
			Prepaid Expenses		7,000
			Cash in Hand		2,000
			Cash at Bank		9,400
		5,05,900			5,05,900

Working Notes:

(*i*) BALANCE SHEET

as on 31st Dec., 2016

Particulars	₹	*Particulars*	₹
Sundry Creditors	2,20,000	Furniture	70,000
Outstanding Expenses	30,000	Stock in trade	70,000
Capital (balancing figure)	1,48,000	Sundry Debtors	2,30,000
		Prepaid Expenses	5,000
		Cash at Bank	20,000
		Cash in Hand	3,000
	3,98,000		3,98,000

NOTES

(*ii*) TOTAL CREDITORS ACCOUNT

Particulars	₹	*Particulars*	₹
To Cash/Bank	3,92,000	By Balance b/d	2,20,000
To Discount	8,000	By Sundry Debtors	
To Bills Receivable	30,000	(Bills dishonoured)	5,000
To Balance c/d	2,60,000	By Purchases	4,65,000
		(balancing figure)	
	6,90,000		6,90,000

(*iii*) Sales during the year:

	₹
Stock on 1st Jan. 2017	70,000
Purchases	4,65,000
	5,35,000
Less: Closing stock *plus* Goods withdrawn	65,000
Cost of Goods sold	4,70,000
Add: Profit margin: 50% on cost or $33\frac{1}{3}$ % on selling price	2,35,000
	7,05,000

(*iv*) TOTAL DEBTORS ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance b/d	2,30,000	By Cash/Bank	5,85,000
To Sales	7,05,000	By Discount	15,000
To Sundry Creditors		By Bills Receivable	1,50,000
(Bills endorsed dishonoured)	5,000	By Balance c/d (balancing figure)	1,90,000
	9,40,000		9,40,000

(*v*) BILLS RECEIVABLE ACCOUNT

Particulars	₹	*Particulars*	₹
To Sundry Debtors	1,50,000	By Sundry Creditors	30,000
		By Cash/Bank	61,250
		By Discount	1,250
		By Balance c/d	57,500
	1,50,000		1,50,000

(*vi*) FURNITURE ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance b/d	70,000	By Depreciation	
To Cash/Bank	20,000	(balancing figure)	8,000
		By Balance c/d	82,000
	90,000		90,000

(*vii*) CASH/BANK ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance b/d	23,000	By Sundry Creditors	3,92,000
To Sundry Debtors	5,85,000	By Furniture	20,000
To Bills Receivable	61,250	By 4% Govt. Securities	96,000
To Sale of Scrap	5,000	By Expenses	2,00,000
To Capital A/c	95,150	By Drawings	50,000
(Capital introduced)		By Balance c/d	11,400
	7,69,400		7,69,400

		₹
(*viii*)	Expenses charged to *P* & *L* A/c	
	Paid	2,00,000
	Add: Outstanding Expenses as on 31.12.2017	15,000
		2,15,000
	Less: Outstanding Expenses as on 31.12.2016	30,000
		1,85,000
	Add: Prepaid Expenses as on 31st Dec. 2016	5,000
		1,90,000
	Less: Prepaid Expenses as on 31st Dec. 2017	7,000
		1,83,000

Check Your Progress

1. How can the sales be ascertained?
2. State the two types of purchases.

4.3 ANSWERS TO CHECK YOUR PROGESS QUESTIONS

1. Sales may be of two types (i) Credit Sales, and (ii) Cash Sales. Credit Sales should be found out by preparing a Total Debtors Account while cash sales should be found out from the Cash Book.
2. The purchases may be of two types (i) Credit purchases, and (ii) Cash purchases. The amount of credit purchases can be ascertained by preparing a Total Creditors Account.

4.4 SUMMARY

- In practice usually Abridged Conversion Method is followed. Under this method, normal accounts are not opened in the ledger, nor a trial balance is prepared. Only such information is collected which is required for preparing the Trading and Profit & Loss Account, and Balance Sheet of the business.
- Sales may be of two types (i) Credit Sales, and (ii) Cash Sales. Credit Sales should be found out by preparing a Total Debtors Account while cash sales should be found out from the Cash Book.
- The purchases may be of two types (i) Credit purchases, and (ii) Cash purchases. The amount of credit purchases can be ascertained by preparing a Total Creditors Account.
- Stocks may be classified into two categories: (i) Opening Stock, and (ii) Closing Stock. The amount of Opening Stock or Closing Stock can be ascertained by preparing a Memorandum Trading Account.

- The balance in the Debtors Account in the beginning of accounting year or at the end of the accounting year can be ascertained by preparing a Total Debtors Account.
- The balance in the Total Creditors Account in the beginning or at the end of the accounting year can be ascertained by preparing a Total Creditors Account.
- The balance of bills receivable at the beginning or at the end of the accounting year can be ascertained by preparing a Bills Receivable Account.
- The balance of the Bills Payable Account at the beginning or at the end of the accounting year can be ascertained by preparing a Bills Payable Account.
- The amount of capital in beginning of the accounting year can be ascertained by preparing a Statement of Affairs which may be called the Balance Sheet of the business in case of Conversion Method.

4.5 KEY WORDS

- **Total debtors account:** The balance of the debtor's control account must equal the total of the debtors' list, which represents the amounts owed by the individual debtors obtained from the individual balances in the various subsidiary ledger accounts for each debtor.
- **Memorandum trading account:** A special account is used to hold excess margin from an investor's margin account. This type of account locks in unrealized gains and increases an investor's buying power. This is also called special memorandum account.

4.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Question

1. Choose the most appropriate answer:
   (i) The amount of opening stock can be ascertained by preparing.
      (a) Memorandum Trading Account
      (b) Total Creditors Account.
      (c) Opening Statement of Affairs.
   (ii) The closing balance in the Creditors Account can be ascertained from
      (a) Cash Account

(b) Total Creditors Account.

(c) Balance Sheet at the end of the accounting period.

(iii) If the rate of gross profit is 25% of sales and the cost of goods sold is ₹1,00,000, the amount of gross profit will be

(a) ₹25,000

(b) ₹33,333.

(c) ₹20,000.

(iv) If the rate of gross profit is 20% on cost of goods sold and the sales are ₹1,00,000, the amount of gross profit will be

(a) ₹20,000

(b) ₹25,000.

(c) ₹16,667.

Long Answer Question

1. Describe in detail the steps required to prepare the final accounts according to the conversion method.
2. Discuss the process of preparing other balances.

4.7 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

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UNIT 5 FINAL ACCOUNTS OF A SOLE TRADER

NOTES

Structure

5.0 INTRODUCTION

In this unit, you will learn about the meaning, objectives and characteristics of final accounts which give an idea about the profitability and financial position of a business to its management, owners, and other interested parties. All business transactions are first recorded in a journal. They are then transferred to a ledger and balanced. These final tallies are prepared for a specific period. The preparation of a final accounting is the last stage of the accounting cycle. It determines the financial position of the business. Under this it is compulsory to make trading account, the profit and loss account and balance sheet. The term 'final accounts' includes the trading account, the profit and loss account, and the balance sheet.

The Trading and Profit and Loss Account is a final summary of such accounts which affect the profit or loss position of the business. In other words, the account contains the items of Incomes and Expenses relating to a particular period. The account is prepared in two parts: (i) Trading Account, and (ii) Profit and Loss Account. The Balance Sheet shows the position of various accounts during the accounting period.

5.1 OBJECTIVES

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

- Discuss the meaning of Final Accounts
- Identify the objectives of Final Accounts

- Describe the characteristics of Final Accounts
- Recall the adjustments made before preparing the Final Accounts
- Describe the meaning and preparation of Trading Account
- Discuss the important points regarding Profit and Loss Account
- Explain the accounting statement Balance Sheet
- Differentiate between Profit &Loss Account and Balance Sheet
- Discuss the differences between Trial Balance and Balance Sheet

5.2 MEANING, OBJECTIVES AND CHARACTERISTICS OF FINAL ACCOUNTS

It has been explained in a preceding unit that the accuracy of the books of accounts is determined by means of preparing a Trial Balance. Having determined the accuracy of the books of accounts every businessman is interested in knowing about two more facts. They are: (*i*) Whether he has earned a profit or suffered a loss during the period covered by the Trial Balance, (*ii*) Where does he stand now? In other words, what is his financial position?

The determination of the Profit or Loss is done by preparing a Trading and Profit and Loss Account (or an Income Statement). While the financial position is judged by means of preparing a Balance Sheet of the business. The two statements together, i.e., Income Statement and the Balance Sheet, are termed as Final Accounts. As the term indicates, Final Accounts means accounts which are prepared at the final stage to give the financial position of the business.

5.2.1 Characteristics of Final Accounts

- It is the final process of accounting.
- It is prepared to show the final result of the company in a specific period.
- It is the account, which is prepared at the end of the given year or period, to see the profit and loss position as well as the financial position of a going concern for the period given.
- It is also known as financial statement.
- It consists of trading account, profit and loss account and balance sheet.
- The trading account shows the gross profit or gross loss, net profit or net loss is calculated from profit and loss account and balance sheet is prepared to know the position of assets and liabilities.

- Profit and loss account shows the profitability achieved during the accounting period and balance sheet reflects the composition of various assets, liabilities, and shareholder's equity on the accounting period.

NOTES

5.2.2 Objectives of Final Accounts

The following are the main objectives of final accounts:

- To determine gross profit and net profit of the business during the year.
- To present the true financial position of the business on a given date.
- To make effective control on financial activities of the business.
- To make a summary presentation of all the financial transactions.
- To communicate the operating results and financial position of the users.
- To help in making a different financial decision to the users of accounting information.

5.3 ADJUSTMENTS BEFORE PREPARING 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. These adjustments usually relate to the following:

1. Closing stock
2. Outstanding expenses
3. Prepaid expenses
4. Outstanding or accrued income
5. Income received in advance or unearned income
6. Depreciation
7. Bad debts
8. Provision for bad debts
9. Provision for discount on debtors
10. Reserve for discount on creditors
11. Interest on capital
12. Interest on drawings

Each of these adjustments are being explained in detail in the following pages:

1. Closing Stock

The following journal entry is passed for the unsold stock at the end of the accounting period:

Closing Stock A/c Dr.
To Trading Account

The stock at the end appears in the Balance Sheet and its balance at the end of the accounting year 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. The Trading Account is debited and the stock in the beginning of the accounting year (which was Closing Stock last year) is credited. Stock Account is thus closed.

Sometimes, the value of the 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. This is because it means that the Closing Stock has already been taken into account while computing the cost of goods sold. This will be clear with the help of the following example:

TRIAL BALANCE

Particulars	*Dr* ₹	*Cr.* ₹
Opening Stock	10,000	
Purchases	30,000	
Sales		40,000

Stock at the end of the accounting year is ₹15,000.

In this case, the Closing Stock has been given outside the Trial Balance and, therefore, the different items will appear in the Final Accounts as follows:

Dr. TRADING ACCOUNT *Cr.*

Particulars	₹	*Particulars*	₹
To Opening Stock	10,000	By Sales	40,000
To Purchases	30,000	By Closing Stock	15,000
To Gross Profit taken to Profit and Loss Account	15,000		
	55,000		55,000

BALANCE SHEET

Liabilities	₹	*Assets*	₹
		Closing Stock	15,000

The Opening and Closing Stocks may both be adjusted with purchases and the cost of sales may be found out separately. In such a case, the items in the Trial Balance will appear as follows:

TRIAL BALANCE

Particulars	*Dr. Amount* ₹	*Cr. Amount.* ₹
Adjusted Purchases or Cost of Sales	25,000	
Sales		40,000
Closing Stock	15,000	

NOTES

The different items will now appear in the Final Accounts as follows:

Dr. TRADING ACCOUNT Cr.

Particulars	₹	Particulars	₹
To Adjusted Purchases	25,000	By Sales	40,000
To Gross Profit taken to Profit and Loss Account	15,000		
	40,000		40,000

BALANCE SHEET

Liabilities	₹	Assets	₹
		Closing Stock	40,000

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 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 and 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.

Illustration 5.1. Following are the extracts from the Trial Balance of a firm as on 31st December, 2017:

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr* ₹	*Cr* ₹
Salaries A/c	10,000	
Rent A/c	5,000	

Additional Information:

(*i*) Salary for the month of December ₹2,000 has not yet been paid.

(*ii*) Rent amounting to ₹1,000 is still outstanding.

NOTES

You are required to pass the necessary adjusting entries and show how the above items will appear in the Firm's Accounts:

Solution:

JOURNAL PROPER

Date	Particulars		Dr. ₹	Cr. ₹
	Salaries A/c	Dr.	2,000	
	To Outstanding Salaries A/c			2,000
	(Being salaries due but not paid)			
	Rent A/c	Dr.	1,000	
	To Outstanding Rent A/c			1,000
	(Being rent due but not paid)			

The items will appear in the Final Accounts as follows:

Dr. PROFIT AND LOSS ACCOUNT *Cr.*

Particulars		₹	Particulars	₹
To Salaries	10,000			
(as given in the T/B)				
Add: Outstanding Salaries	2,000	12,000		
To Rent	5,000			
(as given in the T/B)				
Add: Outstanding Rent	1,000	6,000		

BALANCE SHEET

Liabilities		₹	Assets	₹
Outstanding Expenses:				
Outstanding Salaries	2,000			
Outstanding Rent	1,000	3,000		

It should be noted that any item given outside the Trial Balance will be recorded at two places on account of Dual Aspect Concept. For example, in the above illustration, the amount of outstanding salaries has been shown in the Profit and Loss Account and also in the Balance Sheet.

However, if the accountant had come to know about these outstanding expenses before closing the books of accounts, the Salaries Account and Outstanding Salaries Account, Rent Account and Outstanding Rent Account would have appeared in the ledger as follows:

Dr. SALARIES ACCOUNT *Cr.*

Particulars	₹	Particulars	₹
To Bank	10,000	By Balance c/d	12,000
To Outstanding Salaries	2,000		
	12,000		12,000

Dr. OUTSTANDING SALARIES ACCOUNT *Cr.*

Particulars	₹	Particulars	₹
To Balance c/d	2,000	By Salaries	2,000
	2,000		2,000

NOTES

RENT ACCOUNT

Particulars	₹	*Particulars*	₹
To Bank	5,000	By Balance c/d	6,000
To Outstanding Rent	1,000		
	6,000		6,000

OUTSTANDING RENT ACCOUNT

Particulars	₹	*Particulars*	₹
To Balance c/d	1,000	By Rent A/c	1,000
	1,000		1,000

The above balances would have appeared in the Trial Balance as follows:

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr* ₹	*Cr* ₹
Salaries A/c	12,000	
Rent A/c	6,000	
Outstanding Salaries A/c		2,000
Outstanding Rent A/c		1,000

The above accounts would have appeared in the Final Accounts as follows:

PROFIT & LOSS ACCOUNT

for the year ending 31.12.2017

Particulars	₹	*Particulars*	₹
To Salaries	12,000		
To Rent	6,000		

BALANCE SHEET

as on 31.12.2017

Liabilities	₹	*Assets*	₹
Outstanding Salaries	2,000		
Outstanding Rent	1,000		

Thus, the position in both the cases is the same. The point to be noted is that any item appearing in the Trial Balance is recorded at only one place in the Final Accounts while any item outside the Trial Balance is recorded at two places in the Final Accounts.

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 bring prepared but they relate to the next period. For example, during the accounting year ending on 31st December, 2017, insurance premium for the year ending 31st March, 2017 might have been paid. It means insurance for three months has been paid in advance. In order to ascertain true profit or loss only expenses relating

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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 and 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 on the Balance Sheet on the assets side.

Illustration 5.2. The following are the extracts from the Trial Balance of a firm as on 31st Dec. 2017.

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr ₹*	*Cr ₹*
Insurance	8,000	
Rent	4,000	

Additional Information:

(i) Insurance premium has been paid in advance amounting to ₹1,000 for the next year.

(ii) Rent ₹500 has been paid for the next year.

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

Solution:

JOURNAL PROPER

Date	*Particulars*		*Dr. ₹*	*Cr. ₹*
2017	Prepaid Insurance A/c	Dr.	1,000	
	To Insurance A/c			1,000
	(Being Insurance premium paid in advance)			
	Prepaid Rent A/c	Dr.	500	
	To Rent A/c			500
	(Being rent paid in advance)			

PROFIT AND LOSS ACCOUNT

as on 31st December, 2017

Particulars		₹	*Particulars*	₹
To Insurance	8,000			
Less: Prepaid	1,000	7,000		
To Rent	4,000			
Less: Prepaid	500	3,500		

BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	*Assets*	₹
		Prepaid Insurance	1,000
		Prepaid Rent	500

NOTES

4. Outstanding Income

Outstanding Income means income which has become due during the accounting year but which has not so far been received by the firm. In order to ascertain the true profit or loss, adjustments for such income must be made in the Final Accounts of the business. The following journal entry will be passed:

Outstanding Income A/c Dr.

To Income A/c

Accrued Income

Accrued income means income which has been earned by the business during the accounting year but which has not yet become due and, therefore, has not been received. Adjusting entry of such income is also on the pattern of outstanding income as shown below:

Accrued Income A/c Dr.

To Income A/c

A distinction has to be made between accrued income and outstanding income. Though, both the incomes have been earned by the business and not yet received but in case of accrued income, the income has not become due to the business while outstanding income is an income which has become due to the business. For example, if a loan of ₹10,000 has been given @ 12% p.a. and interest is payable monthly, if interest for one month, *i.e.*, ₹100 has not been received by the business, the income will be termed as an Outstanding Income since interest has become due but it has not yet been received by the business. However, in case of these securities where interest is payable on definite dates, interest may have been earned by the business, but it will become due not earlier than the definite date. For example, if a business has purchased 6% Government Securities of ₹10,000 on which interest is payable on 31st March and 30th September, for the accounting year ending on 31st December interest for 3 months (*i.e.*, ₹150 for October, November and December) will be taken as accrued interest and not an outstanding interest. This is because interest will become due after 30th September, only on 31st March and not earlier.

Illustration 5.3. The following are the extracts from the Trial Balance of a firm on 31st Dec. 2017.

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Particulars	Dr. ₹	Cr. ₹
6% Loan	20,000	
Investments in 6% Debentures of '*B*' Ltd. (Interest payable on 31st March and 30th Sept.)	30,000	
Interest on loan received up to 31st October, 2017		1,000
Interest on Investments		900

Solution:

In the above case, interest on loan for a period of two months is still outstanding. The amount of such interest is ₹200. In case of debentures, interest for three months has been earned by the business but it has not become due. The amount of accrued interest, therefore, comes to ₹450. The following adjusting entries will, therefore, be passed in the journal proper.

Date	Particulars	Dr. ₹	Cr. ₹
	Outstanding Interest A/c Dr.	200	
	To Interest A/c		200
	(Being interest on loan due but not received)		
	Accrued Interest A/c	450	
	To Interest on Investments A/c		450
	(Being interest earned, not due and not received)		

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 'assets side' in the Balance Sheet. Interest Account is a nominal account, and it has been credited. The amount of interest will, therefore, be added to the amount of interest already appearing in the Trial Balance.

The items will appear in the Final Accounts as follows:

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars	₹	Particulars		₹
		By Interest on Loan	1,000	
		Add: Outstanding Interest	200	1,200
		By Interest on Investments	900	
		Add: Accrued Interest	450	1,350

BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	Assets	₹
		Outstanding Interest A/c	200
		Accrued Interest A/c	450

5. Income Received in Advance

Income received in advance means income which has been received by the business before it is 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 and 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

Illustration 5.4. The following are the extracts from the Trial Balance of a firm on 31st December, 2017. You are required to pass the necessary adjustment entries and show how the various will appear in the firm's Final Accounts.

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Rent received for 12 months ending 31st March, 2017		1,200
Interest on Loan		2,000

Additional Information:

Interest on Loan has been received in advance to the extent of ₹500.

Solution:

JOURNAL ENTRIES

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	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 AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars	₹	*Particulars*		₹
		By Interest	2,000	
		Less: Received in advance	500	1,500
		By Rent	1,200	
		Less: Received in advance	300	900

BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	*Assets*	₹
Rent received in advance	300		
Interest received in advance	500		

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

NOTES

Illustration 5.5. The following are the extracts from the Trial Balance of a firm.

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Plant	30,000	
Buildings	50,000	

Additional Information:

(i) Charge depreciation on plant @ 10% per annum,

(ii) Charge depreciation on buildings @ 5% per annum.

Solution:

JOURNAL ENTRIES

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Depreciation A/c	Dr.	5,500	
	To Plant A/c			3,000
	To Buildings A/c			2,500
	(Being depreciation charged on Plant and Buildings)			

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	*Particulars*	₹
To Depreciation:				
Plant	3,000			
Buildings	2,500	5,500		

BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	*Assets*		₹
		Plant	30,000	
		Less: Depreciation	3,000	27,000
		Buildings	50,000	
		Less: Depreciation	2,500	47,500

Depreciation on Assets acquired during the course of the year.

Sometimes, fixed assets are acquired during the course of the year. In such a case, the problem arises whether depreciation should be charged for the full accounting year or it should be charged only for a part of the accounting year. In such a situation in the absence of any specific instructions in the question, it will be appropriate to charge depreciation for the full year even in respect of those assets which have been acquired during the course of the year. However, where depreciation rate has been given as per annum and the date of acquisition of the fixed assets has been given, it will be appropriate to charge depreciation only for the remaining part of the accounting year.

Illustration 5.6. The following are the extracts from the Trial Balance of a firm.

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Furniture and Fixtures	10,000	
Plant and Machinery	40,000	

Additional Information:

(i) Furniture of ₹5,000 was purchased on 1st July, 2017. Charge depreciation @ 10% p.a.

(ii) Plant of ₹10,000 was acquired on 1st July, 2017. Charge depreciation @20%.

Pass the necessary journal entries and show how the items will appear in the firm Final Accounts:

Solution:

JOURNAL ENTRIES

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Depreciation A/c Dr.	8,750	
	To Furniture & Fixtures A/c		750
	To Plant and Machinery A/c		8,000
	(Being depreciation charged on furniture and fixtures and Plant and Machinery including additions)		

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	*Particulars*	₹
To Depreciation:				
Furniture and Fixtures	750			
Plant and Machinery	8,000	8,750		

BALANCE SHEET

as an 31st December, 2017

Particulars	₹	*Particulars*		₹
		Furniture & Fixtures	10,000	
		Less: Depreciation	750	9,250
		Plant & Machinery	40,000	
		Less: Depreciation	8,000	32,000

Notes:

(*i*) Since depreciation has been given on furniture at 10% p.a., depreciation for only 6 months has been charged for furniture acquired on 1st July, 2017.

(*ii*) In case of plant, the rate of depreciation has been given as 20%, hence, depreciation for the full year has been charged even on plant which has been acquired on 1st July, 2017.

Tutorial Note. The students should give note regarding their workings. In case the question regarding charging of depreciation on additions to fixed assets made during the year is silent, the students can also presume that no depreciation is to be charged on additions. However, a specific note should be given to that effect.

7. Bad Debts

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 debtor. The following journal entry should, therefore, be passed in the event of a debt becoming bad.

Bad Debts A/c Dr.
To Debtor's Personal A/c

Illustration 5.7. The following are the extracts from Trial Balance of a business.

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Sundry Debtors	50,000	
Bad Debtors	5,000	

Additional Information:

Mahesh, one of the debtors, became insolvent and it was learnt on 31st December, that out of the total debt of ₹5,000 only ₹2,500 will be recovered from him. No adjustment has so far been made.

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

Solution:

JOURNAL

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Bad Debts A/c Dr. To Mahesh (Being ₹2,500 became irrecoverable)	2,500	 2,500

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	*Particulars*	₹
To Bad Debts (as given in the Trial Balance)	5,000			
Add: Additional bad debts	2,500	7,500		

BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	*Assets*		₹
		Sundry Debtors	50,000	
		Less: Bad Debts	2,500	47,500

8. Provision for Bad Debts

In an earlier unit, we have already explained that in accounting we observe the "convention of conservatism" while recording business transactions. This means that we make provision for expected 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.

Illustration 5.8. The following are the extracts from the Trial Balance of a firm.

TRIAL BALANCE

as on 31st December, 2017

Particulars	₹	₹
Sundry Debtors	30,000	
Bad Debts	5,000	

Additional Information:

(i) After preparing the Trial Balance, it is learnt that a debtor Ramesh has become insolvent and, therefore, the entire amount of ₹3,000 due from him was irrecoverable.

(ii) Create 10% provision for bad and doubtful debts.

You are required to pass necessary adjusting entries and show how the items will appear in the firm's Balance Sheet.

NOTES

Solution:

ADJUSTING JOURNAL ENTRIES

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Bad Debts A/c	Dr.	3,000	
	To Ramesh			3,000
	(Being amount due from Ramesh proved to be bad)			
	Profit & Loss A/c	Dr.	2,700	
	To Provision for Bad and Doubtful Debts			2,700
	(Being bad debts provision created)			

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	*Particulars*	₹
To Bad Debts	5,000			
(as given in th Trial Balance)				
Add : Additional bad debts	3,000			
Add : Provision for bad debts	2,700	10,700		

BALANCE SHEET

as on 31st December, 2017

Particulars	₹	*Particulars*		₹
		Sundry Debtors	30,000	
		Less: Additional bad debts	3,000	
			27,000	
		Less: Provision for bad debts	2,700	24,300

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.

Illustration 5.9. The following are the extracts from the Trial Balance of a firm:

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Sundry Debtors	50,000	
Provision for Doubtful Debts		5,000
Bad Debts	3,000	

Additional Information:

(*i*) Additional bad debts ₹3,000.

(*ii*) Keep the provision for bad debts @ 10% on debtors.

You are required to pass the necessary journal entries and prepare Provision for Doubtful Debts Account and show how the different items will appear in the firm's Final Accounts.

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JOURNAL ENTRIES

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Bad Debts A/c	Dr.	3,000	
	To Sundry Debtors			3,000
	(Being additional bad debts of ₹3,000)			
	Provision for Bad Debts A/c	Dr.	6,000	
	To Bad Debts A/c			6,000
	(Being bad debts, ₹3,000 appearing in the Trial Balance + ₹3,000 additional bad debts, transferred to Provision for Bad Debts A/c)			
	Profit and Loss A/c	Dr.	5,700	
	To Provision for Bad Debts A/c			5,700
	(Being amount charged from *P* & *L* A/c to keep provision for bad debts @10% on debtors)			

PROVISION FOR BAD DEBTS ACCOUNT

Particulars	₹	*Particulars*	₹
To Bad Debts A/c	6,000	By Balance b/d	5,000
To Balance c/d	4,700	By Profit & Loss A/c	5,700
	10,700		10,700

PROFIT AND LOSS ACCOUNT
as on 31st December, 2017

Particulars		₹	*Particulars*	₹
To Bad Debts (as given in the Trial Balance)	3,000			
Add: Additional bad debts	3,000			
	6,000			
Add: New provision for bad debts	4,700			
	10,700			
Less: Old provision for bad debts	5,000	5,700		

BALANCE SHEET
as on 31st December, 2017

Liabilities	₹	*Assets*		₹
		Sundry Debtors	50,000	
		Less : Additional bad debts	3,000	
			47,000	
		Less : New provision for bad debts	4,700	42,300

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, the following journal entry is passed:

Discount A/c Dr.
    To Debtor's Personal A/c

NOTES

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 and Loss A/c Dr.
To Provision for Discount A/c

It should be noted that '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 debtors' balances.

Illustration 5.10. The following are the extracts from the Trial Balance of a firm:

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Sundry Debtors	50,000	
Bad Debts	3,000	
Discount	2,000	

9. Additional Information:

(i) Create a provision for doubtful debts @ 10% on debtors.

(ii) Create a provision for discount on debtors @ 5% on debtors.

(iii) Additional discount given to the debtors ₹1,000.

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

Solution:

JOURNAL ENTRIES

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	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 Debts A/c (Being provision for bad debts created @10% on debtors of ₹49,000)	4,900	 4,900
	Profit & Loss A/c Dr. To Provision for Discount (Being provision for discount created @5% on debtors of ₹44,100 (*i.e.,* ₹49,000 – ₹4,900)	2,205	 2,205

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	*Particulars*	₹
To Bad Debts (as given in the Trial Balance)	3,000			
Add: Provision for bad debts	4,900	7,900		
To Discount (as given in the Trial Balance)	2,000			
Add: Additional discount	1,000			
Add: Provision for discount	2,205	5,205		

BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	*Assets*		₹
		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

Illustration 5.11. The following are the extracts from the Trial Balance of a firm:

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Sundry Debtors	50,000	
Provision for Bad Debts		5,000
Provision for Discount		2,000
Bad Debts	3,000	
Discount	1,000	

Additional Information:

(i) Additional Bad Debts ₹1,000.

(ii) Additional Discount ₹500.

(iii) Create a provision for bad debts @10% on debtors.

(iv) Create a provision for discount @5% on debtors.

Pass the necessary journal entries, prepare Provision for Bad Debts Account and Provision for Discount on Debtors Account and show how the different items will appear in the Firm's Final Accounts.

Solution:

JOURNAL ENTRIES

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Bad Debts A/c	Dr.	1,000	
	Discount A/c	Dr.	500	
	To Sundry Debtors			1,500
	(Being additional bad debts and additional discount on debtors)			
	Provision for Bad Debts A/c	Dr.	4,000	
	To Bad Debts A/c			4,000
	(Being bad debts written off from Provision for Bad Debts A/c)			
	Provision for Discount on Debtors A/c	Dr.	1,500	
	To Discount A/c			1,500
	(Being discount allowed written off from Provision for Discount on Debtors A/c)			
	Profit and Loss A/c	Dr.	3,850	
	To Provision for Bad Debts A/c			3,850
	(Being amount charged from *P* & *L* A/c to maintain a provision of 10% for bad debts on debtors amounting to ₹48,500)			
	Profit and Loss A/c	Dr.	1,682.50	
	To Provision for Discount A/c			1,682.50
	(Being amount charged from *P* & *L* A/c for keeping the provision for discount @5% on good debtors amounting to ₹43,650)			

PROVISION FOR BAD DEBTS ACCOUNT

Particulars	₹	*Particulars*	₹
To Bad Debts A/c	4,000	By Balance b/d	5,000
To Balance c/d	4,850	By Profit & Loss A/c	3,850
	8,850		8,850

PROVISION FOR BAD DEBTS ACCOUNT

Particulars	₹	*Particulars*	₹
To Discount A/c	1,500.00	By Balance b/d	2,000.00
To Balance c/d	2,182.50	By *P* & *L* A/c	1,682.50
	3,682.50		3,682.50

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	*Particulars*	₹
To Bad Debts (as given in the Trial Balance)	3,000.00			
Add: Additional bad debts	1,000.00			
Add: New provision for bad debts	4,850.00			
	8,850.00			
Less: Old provision for bad debts	5,000.00	3,850		
To Discount (as given in the Trial Balance)	1,000.00			

NOTES

Particulars	₹	*Particulars*	₹
Add: Additional discount 500.00 *Add:* New provision for discount 2,182.50 3,682.50 *Less:* Old provision 2,000.00	1,682.50		

BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	*Assets*	₹
		Sundry Debtors 50,000 *Less:* Additional bad debts and additional discount 1,500 48,500 *Less:* New provision for bad debts 4,850 43,650 *Less:* New provision for discount 2,182.50	41,467.50

10. Reserve 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, therefore, 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 and Loss A/c

Illustration 5.12. The following are the extracts from the Trial Balance of a firm.

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Sundry Creditors		30,000
Discount		1,000
Reserve for Discount on Creditors	2,000	

Additional Information:

(i) Additional discount received from creditors after closing the accounts ₹1,500.

(ii) Create a reserve for discount on creditors @10%.

NOTES

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

Solution:

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Sundry Creditors A/c Dr. To Discount A/c (Being additional discount received from Creditors)	1,500	 1,500
	Discount A/c Dr. To Reserve for Discount on Creditors (Being discount received transferred to Reserve for Discount A/c)	2,500	 2,500
	Reserve for Discount A/c Dr. To Profit and Loss A/c (Being amount credited to Profit and Loss Account for maintaining Reserve for Discount Account @10% on creditors)	3,350	 3,350

Dr. RESERVE FOR DISCOUNT ON CREDITORS ACCOUNT *Cr.*

Particulars	₹	*Particulars*	₹
To Balance b/d	2,000	By Discount A/c	2,500
To Profit and Loss Account	3,350	By Balance c/d	2,850
	5,350		5,350

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars	₹	*Particulars*		₹
		By Discount (as given in the Trial Balance)	1,000	
		Add: Additional discount received	1,500	
		Add: New Reserve for discount	2,850	
			5,350	
		Less: Old Reserve for discount	2,000	3,350

11. Interest on Capital

Funds provided by the proprietor to run the business is termed as Capital. In order to determine the real 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

In case of a partnership firm, interest will be allowed on the capital of each partner. The following journal entry will be passed:

Interest on Capital A/c Dr.
To Partner's Capital Account

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.

Illustration 5.13. The following are the extracts from the Trial Balance of a firm:

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Capital Accounts:		
Ramesh		30,000
Suresh		20,000

Additional Information:

(*i*) Interest on capital is to be allowed @ 10% p.a.

(*ii*) Suresh introduced additional capital amounting to ₹5,000 on 1st July, 2017.

You are required to pass the necessary journal entries and show how the different items will appear in the Firm's Final Accounts.

Solution:

JOURNAL ENTRIES

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Interest on Capital A/c Dr.	4,750	
	To Ramesh's Capital A/c		3,000
	To Suresh's Capital A/c		1,750
	(Being interest on capital allowed to Ramesh on ₹30,000 for full year and to Suresh on ₹15,000 for full year and on ₹5,000 for 6 months)		

BALANCE SHEET
as on 31st December, 2017

Liabilities		₹	*Assets*	₹
Capital Accounts:				
Ramesh	30,000			
Add: Interest on capital	3,000	33,000		
Suresh	20,000			
Add: Interest on capital	1,750	21,750		

PROFIT AND LOSS ACCOUNT
for the year ending 31st December, 2017

Particulars		₹	*Particulars*	₹
To Interest on Capital:				
Ramesh	3,000			
Suresh	1,750	4,750		

NOTES

12. Interest on Drawings

Drawings denote the money withdrawn by the proprietor from the business for his personal use. It is 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	

In case of a partnership firm, interest on drawings will be charged on the drawings made by each partner. The journal entry will be as follows:

Partners Capital/Current Accounts*	Dr.
To Interest on Drawings A/c	

Computation of Interest on Drawings There is a difference between the method of computation of interest on capital and computation of interest on drawings. In most cases, interest on capital is charged on the opening balance in the Capital Account. However, in case of additional capital introduced during the year by the proprietor, interest may be charged from the date of introducing additional capital till the end of the accounting period. This does not create much problem. However, in case of drawings, the things are different. The proprietor does not usually make the entire amount of drawings on a particular date for the whole accounting year.

For example, if the proprietor has withdrawn ₹12,000 from the business, it cannot reasonably be pressumed that he must have withdrawn the entire amount in the beginning of the accounting year.

Since, the interest is to be charged on the amount withdrawn by the proprietor from the date on which he withdrew the amount from the business till the end of the accounting period, it requires computation of interest on each withdrawal made by the proprietor separately. In the absence of any specific information, it can reasonably be presumed that the drawings were made evenly throughout the year. Moreover, for computation of interest, any of the following three presumptions can reasonably be made:

(*i*) The proprietor withdrew the money on the 1st of each month. In such a case, interest should be charged for $6^1/_2$ months on the total amount at the given rate of interest.

* Partners Capital Accounts can be maintained either on a Fixed or a Fluctuating Capital System. In case of a Fixed Capital System, two accounts are maintained for each partner. (i) Capital Account, and (ii) Current Account. Capital Account is credited with the amount of capital introduced by the partner or debited with the amount of capital withdrawn by the partner, while all adjustments regarding interest on capital, share of profit, drawings, etc., are made in the Current Accounts. Thus, balance in the Capital Account remains more or less fixed. This is the reason for calling it as a Fixed Capital System. In case of Fluctuating Capital System all adjustments regarding capital, drawings, interest, share or profit etc. are made only in the Capital Account. Thus, the balance of the Capital Account goes on fluctuating. This is the reason for calling this system as Fluctuating Capital System.

NOTES

(*ii*) The proprietor withdrew the money on the 15th of each month. In such a case, interest should be charged on the total amount of drawings for six months.

(*iii*) The proprietor withdrew the money at the end of each month. In such a case, interest should be charged on the total amount for $5^1/_2$ months.

Tutorial Note. The students may adopt the second presumption in the absence of any specific instructions in the question.

Illustration 5.14. The following are the extracts from the Trial Balance of a Firm.

TRIAL BALANCE

as on 31st December, 2017

Particulars	*Dr.* ₹	*Cr.* ₹
Capital Accounts:		
A's Capital		30,000
B's Capital		20,000
Drawings:		
A	6,000	
B	3,000	

Additional Information:

(i) 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.

(ii) Interest on drawings is to be charged @ 12% p.a.

You are required to pass the necessary journal entries and show how the different items will appear in the Firm's Final Accounts. You may presume that the drawings were made evenly throughout the year on 15th of each month.

Solution:

JOURNAL ENTRIES

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

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	*Particulars*		₹
To Interest on Capital:			By Interest on Drawings:		
A	3,000		*A*	360	
B	2,000	5,000	*B*	180	540

NOTES

BALANCE SHEET

as on 31st December, 2017

Liabilities		₹	*Assets*	₹
Capital Accounts:				
A's Capital	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	20,000			
Add: Interest on Capital	2,000			
	22,000			
Less: Drawings	3,000			
	19,000			
Less: Interest on Drawings	180	18,820		

More Illustrations on Adjustment

Example 1

From the following Trial balance of Rajesh prepare Trading and Profit and Loss Account for the year ended March 31, 2017 and Balance Sheet as on that date.

Trial Balance as on March 31, 2017

Name of the Account	**Dr. Balance**	**Cr. Balances**
	₹	₹
Stock on April 1, 2016	24,200	
Cash in hand	4,000	
Cash at bank	12,900	
Leasehold Premises (Lease for five years commencing from April 1, 2016	20,000	
Machinery	30,000	
Furniture	15,000	
Buildings	60,000	
Drawings	5,000	
Capital		1,60,000
Purchases and Sales	96,000	1,45,000
Debtors and Creditors	50,000	40,000
Returns	3,000	4,300
Freight	6,000	
Wages	17,500	
Trade Expenses	4,750	
Salaries	12,000	
Printing and Stationery	1,800	

NOTES

Bad Bebts	4,000	
Provision for Bad Bebts		4,000
Rent received		3,100
10% Loan (taken on October 1, 2016)		10,000
Interest on Loan	250	
Total	3,66,400	3,66,400

Additional Information

(i) Stock on March 31, 2017 was valued at ₹ 45,600.

(ii) Write off ₹ 2,000 as bad debts and make a provision for doubtful debts at 5% on studry debtors.

(iii) Charge depreciation on Machinery at 10% and on Building at 2.5%.

(iv) Calculate interest on capital and drawings at 6% per annum.

(v) The Manager is entitled to a commission of 5% on the net profit before charging.

Solution:

Trading and P & L Account of Rajesh
for the year ended march 31, 2017

Dr. **Cr.**

Particulars	Amount	Amount	Particulars	Amount	Amount
	₹	₹		₹	₹
To Stock, April 1, 2016		24, 200	By Sales	1,45,000	
To Purchases	96,000		Less Returens Inwares	3,000	1,42,000
Less Returens Outwards	4,300	91, 700	By Stock on March 31, 2017		45,600
To Freight		6,000			
To Wages		17,500			
To Grosss Profit c/d		48,200			
		1,87,600			1,87,600
To Salaries		12,000	By Gross Profit b/d		48,200
To Printing & Stationery		1,800	By Rent Received		3,100
			By Interest on Drawings		150
To Trade Expenses		4,750			
To Provision for					
Bad Debts:	2,400				
Add Bad Debts	6,000				
	8,400				
Less Existing Provision	4,000	4,400			

To Depreciation on:					
Machinery	3,000				
Building	1,500	4,500			
To Leasehold Premises					
-1/5 written off		4,000			
To Interest on loan	250				
Add Outstanding	250	500			
To Interest on Capital		9,600			
To Commission to Manager		495			
To Net Profit (transferred to Capital A/c)		9,405			
		51,450			51,450

Balance Sheet of Rajesh as on March 21, 2017

Particulars	Amount	Amount	Particulars	Amount	Amount
	₹	₹		₹	₹
Curent Liabilities:			Current Assets:		
Outstanding Interest on Loan		250	Cash in hand		4,000
			Cash at bank		12,900
Outstanding Commission to Manager		495	Debtors	50,000	
			Less Bad Debts	2,000	
Creditors		40,000		48,000	
			Less Provision for Bad Debts	2,400	45,600
Long-term Laibilities:					
10% loan		10,000	Closing Stock		45,600
Capital:			Fixed Assets:		
Balance on 1-4-1986	1,60,000		Leasehold Premises	20,000	
Add Interest on Capital	9,600		Less 1/5 written off	4,000	16,000
Net Profit for the year	9,405				
	1,79,005		Furniture		15,000
Less Drawing 5,000			Machinery	30,000	
Interest on			Less Depreciation at 10%	3,000	27,000
Drawings 150	5,150	1,73,855	Building	60,000	
			Less Depreciation at 2.5%	1,500	58,500
		2,24,600			2,24,600

Example 2

Following are the closing balances in the ledger of Suresh for the year ended June 30, 1987:

Debit Balances	₹	Credit Balances	₹
Opening Stock	12,600	Capital	60,000
Purchases	45,000	Sales	1,00, 000
Sales Returns	500	Purchases Returns	1,000
Wages	7,500	Provision for Bad Debts	2,000

Carriage on Purchases	1,100	12% Bank Loan	20,000
Duty and Clearing Charges	800	Sundry Creditors	11,560
Salaries	5,200	Rent Received	3,000
Taxes and Insurance	1,700	Discount	1,440
Advertising	2,800		
Drawings	5,000		
Bills Receivable	3,500		
Debtors	52,000		
Cash in hand	1,500		
Building	28,000		
Furniture	10,000		
Machinery	15,000		
Printing and Stationery	4,400		
Interest on Bank Loan	2,400		
	1,99,000		1,99,000

Prepare Trading and Profit and Loss Account for the year ended June 30, 2017 and Balance Sheet as on that date after taking into account the following information:

(i) The stock on June 30, 2017 was valued at ₹ 26,800.

(ii) The proprietor had taken away goods worth ₹ 3,000 for personal use. This has not been recorded in books.

(iii) Depreciate Machinery at 20%.

(iv) Provision for Bad Debts required is ₹ 1,500.

(v) Provide for Manager's Commission at 10% on the net profit after charging such commission.

Solution:

Trading and Profit and Loss Account of Suresh
for the year ended June 30, 2017

Dr. **Cr.**

Particulars	Amount	Amount	Particulars	Amount	Amount
	₹	₹		₹	₹
To Opening Stock		12,600	By Sales	1,00,000	
To Purchases	45,000		Less: Sales Returns	500	99,500
Less Drawings of Goods	3,000		By Closiing Stock		26,800
	42,000				
Less Purchases Returns	1,000	41,000			
To Carriage on Purchases		1,100			
To Duty and Clearing Charges		800			
To Wages		7,500			

To Gross Profit c/d		63,300			
		1,26,300			1,26,300
To Salaries		5,200	By Gross Profit b/d		63,300
To Taxes and Insurance		1,700	By Rent Received		3,000
To Printing and Stationery		4,400	By Discount Received		1,400
To Advertisment		2,800	By Provision for Bad Debts		
To Interest on Bank Loan		2,400	Existing Provision	2,000	
To Depreciation		3,000	Less: Provision Required	1,500	500
To Commission to Manager		4,431			
To Net Profit (Transferred to Capital A/c		44,309			
		68,240			68,240

Balance Sheet of Suresh as on June 30, 2017

Liabilities	Amount	Amount	Assets	Amount	Amount
	₹	₹		₹	₹
Current Liabilities:			*Current Assets:*		
Outstanding Commission to Manager		4,431	Cash in hand		1,500
Sundry Creditors		11,560	Bills Receivable		3,500
Long-term Laibilities:			Debtors	52,000	
12% Bank Loan		20,000	Less Provision for Bad Debts	1,500	50,500
Capital:			Closing Stock		26,800
Balance on 1-7-2016	60,000		*Fixed Assets:*		
Add Net Profit	44,309		Furniture		10,000
	1,04, 309		Machinery	15,000	
Less Drawings			Less Depreciation	3,000	12,000
(including drawings of goods)	8,000	96,309	Building		28,000
		1,32, 300			1,32,300

Example 3

The Trial Balance of Sultan Singh as on December 31, 2016 was as under:

Name of the Account	Dr.	Cr.
	₹	₹
Capital		1,10,000
Drawings	15,000	
Gross Profit earned during 2016		32,400
Salaries and Wages	22,000	
Rent and Taxes	8,400	

NOTES

Cash in hand	2,300	
Bank Overdraft		8,600
Sundry Debtors and Creditors	41,000	36,000
Insurance (including premium or ₹ 400 per annum paid up to march 31, 1987)	1,000	
Loose Tools	5,000	
Bad Debts	500	
Provision for Bad Debts		800
Entertainment Expenses	300	
Commission		2,100
General Charges	2,600	
Furniture and Fixtures	12,000	
Plant and Machinery	60,000	
Stock on December 31, 2016	19,800	
	1,89,900	1,89,900

Prepare Profit and Loss Account for the year ended December 31, 2016 and Balance Sheet on that date, after keeping in view the following adjustments:

(i) Depreciate Furniture and Fixtures by 5% and Plant and Machinery by 10%.

(ii) The value of Loose Tools on December 31, 1986 was ₹ 4,500.

(iii) Outstanding salaries ₹ 2,000.

(iv) Commission earned but not received amounted to ₹ 400.

(v) Write off further bad debts ₹ 1,000 and maintain the provision for bad debts at.

Solution:

Profit and Loss Account of Sultan Singh
for the year ended December 31, 2016

Dr. **Cr.**

Particulars	Amount	Amount	Particulars	Amount	Amount
	₹	₹		₹	₹
To Salaries and Wages	22,000		By Gross Profit		
Add Outstanding	2,000	24,000	(Transferred from Trading A/c)		32,400
To Rent and Taxes		8,400	By Commission	2,100	
To Insurance	1,000		Add Outstanding	400	2,500
Less Prepaid	100	900	By Net Loss (Transferred to Capital Account)		11,100
To Entertainment Expenses		300			
To General Charges		2600			
To Provision of Bad Debts:					

Provision Required	2,000				
Add Bad Debts	1,500				
	3,500				
Less Existing Provision	800	2,700			
To Depreciation on:					
Furniture & Fixtures					
Plant & Machinery Loose Tools		7,100			
		46,000			46,000

Balance Sheet of Sultan Singh as on December 31, 2016

Liabilities	Amount	Amount	Assets	Amount	Amount
	₹	₹		₹	₹
Current Liabilities:			*Current Assets:*		
Outstanding Salaries		2,000	Cash in hand		2,300
Bank Overdraft		8,600	Sundry Debtors	41,000	
Sundry Creditors		36,000	Less Bad Debts	1,000	
Long-Term Liabilities				40,000	
Capital:			Less Provision of Bad Debts	2,000	38,000
Balance on 1-1-2016	1,10,000		Outstanding Commission		400
Less Net loss for the year 11,100			Closing Stock		19,800
Drawings 15,000	26,100	83,900	Prepaid Insurance		100
			Fixed Assets:		
			Furniture and Fixtures	12,000	
			Less Depreciation at 5%	600	11,400
			Loose Tools	5,000	
			Less Depreciation at	500	4,500
			Plant and Machinery	60,000	
			Less Depreciation at 10%	6,000	54,000
		1,30,500			1,30,500

Example 4

1. The Balance Sheet of XYZ Limited as of March 31, 2018 is as follows:

Particulars	₹	Particulars	₹
Trade Payables	10,00,000	Furniture and Fixtures	5,00,000
Capital	15,00,000	Trade Receivables	7,00,000
		Cash at Bank	7,00,000
		Inventories	5,00,000
Total	**25,00,000**	**Total**	**25,00,000**

Net Profit as on March 31, 2018, was ₹ 14, 50,000.

Adjustments

(i) Outstanding salary of ₹ 5,40,000
(ii) Prepaid Insurance of ₹ 3,20,000.
(iii) Charge Depreciation on Furniture @10%.
(iv) Create a Provision for doubtful debts @5%.

Prepare closing entries for the above items. Also, prepare revised Trading and Profit and Loss Account and Balance Sheet.

Solution

Journal Entries

Date	Particulars		Amount (Dr)	Amount (Cr)
31 Mar	Salary A/c	Dr	5,40,000	
	To Outstanding Salary A/c			5,40,000
	(Being outstanding salary recorded)			
31 Mar	Prepaid Insurance A/c	Dr	3,20,000	
	To Insurance A/c			3,20,000
	(Being prepaid Insurance recorded)			
31 Mar	Profit and Loss A/c	Dr	50,000	
	To Depreciation A/c			50,000
	(Being depreciation charged @10%)			
31 Mar	Profit and Loss A/c	Dr	35,000	
	To Provision for Doubtful Debt A/c			35,000
	(Being provision for doubtful debts created @5%)			

Revised Profit and Loss A/c

Particulars	₹	Particulars	₹
To Outstanding Salary	5,40,000	By balance b/d	14,50,000
To Depreciation	50,000	By Prepaid Insurance	3,20,000
To Provision for Doubtful Debt	35,000		
To Net Profit	11,45,000		
Total	**17,70,000**		**17,70,000**

Revised Balance Sheet as of March 31, 2018

Liabilities		₹	Assets		₹
Trade Payables		**10,00,000**	Furniture and Fixtures	5,00,000	
Capital	15,00,000		Less- Depreciation	50,000	**4,50,000**
Less- Net Loss	3,05,000	**11,95,000**	Trade Receivables	7,00,000	
Outstanding Liabilities		**5,40,000**	Less- Provision for Bad and Doubtful Debts	35,000	**6,65,000**
			Cash at Bank		**7,00,000**
			Inventories		**5,00,000**
			Prepaid Insurance		**3,20,000**
Total		**27,35,000**	**Total**		**27,35,000**

Check Your Progress

1. Name the two statements which are together termed as Final Accounts.
2. How is closing stock accounted for in the Trading Account?
3. Mention how Outstanding Salaries are shown in the books of accounts.
4. State the difference between accrued and outstanding income.
5. Mention the accounting entry for provision for Discount on debtors.

5.4 TRADING ACCOUNT

Trading Account gives the overall result of trading, *i.e.*, purchasing and selling of goods. In other words, it explains whether purchasing of goods and selling them has 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.

This will be clear with the help of the following illustration:

Illustration 5.15. The following figures have been taken from the Trial Balance of a trader:

	₹
Purchases	30,000
Purchases Returns	5,000
Sales	40,000
Sales Returns	5,000

Calculate the amount of profit or loss made by the trader.

Solution:

The profit or loss made by the trader can be found out by comparing the cost of goods sold with sales value. This has been done as follows:

Particulars	*Amount ₹*	*Amount ₹*
Sales	40,000	
Less Sales Returns	5,000	35,000
Purchases	30,000	
Less Purchases Returns	5,000	25,000
Gross Profit		10,000

Opening and Closing Stocks

In Illustration 5.15, we have presumed that all goods purchased have been sold away by the trader. However, it does not normally happen. At the end of the accounting year, a trader may be left with certain unsold goods. Such stock of goods with a

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trader unsold at the end of the accounting period is termed as Closing Stock. Such a stock will become the opening stock for the next period. For example, if a trader has with himself goods amounting to ₹5,000 unsold at the end of the year 2017, this stock of ₹5,000 will be termed as his Closing Stock. For the year 2017, this stock of ₹5,000 will be termed as his Opening Stock. While calculating the amount of profit or loss on account of trading, a trader will have to take such Opening and Closing Stocks into consideration. This will be clear with the help of the following illustration.

Illustration 5.16. Taking the figures given in Illustration 5.1, calculate the amount of Gross Profit if stock of ₹5,000 is left at the end of the accounting period.

Solution:

In case all goods purchased have not been sold away, goods of ₹5,000 are still left with the trader. Stock of such goods is termed as Closing Stock. Thus, cost of goods sold will be calculated as follows:

COST OF GOODS SOLD = NET PURCHASES – CLOSING STOCK

= ₹25,000 – 5,000 = ₹20,000

The Gross Profit now can be computed as follows:

GROSS PROFIT= NET SALES – COST OF GOODS SOLD

= ₹35,000 – 20,000 = ₹15,000

Illustration 5.17. From the following data calculate the profit made by a trader in 2017.

	₹
Stock of goods on 1.1.2017	10,000
Purchases during the year	40,000
Purchases Returns during the year	3,000
Sales during the year	60,000
Sales returns during the year	10,000
Stock of goods on 31.12.2017	15,000

Solution:

Particulars	*Amount* ₹	*Amount* ₹
Sales	60,000	
Less: Sales Returns	10,000	50,000
Cost of goods sold:		
Opening Stock	10,000	
Add: Net Purchases (₹40,000 – 5,000)	35,000	
	45,000	
Less: Closing Stock	15,000	30,000
Gross Profit		20,000

Expenses on Purchases etc.

In the Illustrations given above, we have presumed that the trader has not incurred any expenses for purchase of goods and bringing them to his shop for sale. However, a trader has to incur various types of expenses for purchasing of goods as well as for bringing them to his shop for sale. Such expenses may include brokerage or commission paid to agents for purchase of goods, cartage or carriage charges for bringing the goods to the trader's shop, wages paid to coolies for transportation of goods etc. All such expenses increase the cost of the goods sold and hence they have also to be included in the cost of purchasing the goods. In other words, cost of goods sold will be calculated as follows:

COST OF GOODS SOLD = OPENING STOCK + NET PURCHASES + EXPENSES ON PURCHASING OF GOODS – CLOSING STOCK

Cost of goods sold calculated as above will then be compared with the net sales to find out the amount of profit or loss made by the business. This will be clear with the following Illustrations.

Illustration 5.18. Calculate the amount of the profit made by the trader with the help of data given in Illustration 5.3, if the wages, carriage charges etc. incurred for bringing the goods to the trader's shop amount to ₹5,000.

Solution:

Particulars	*Amount* ₹
Net Sales	50,000
Less: Cost of goods sold (30,000 + 5,000)	35,000
Gross Profit	15,000

The term 'merchandise' is also used for the term 'goods'.

Thus:

COST OF GOODS	=	**COST OF MERCHANDISE**
COST OF GOODS PURCHASED	=	**COST OF MERCHANDISE PURCHASED**
COST OF GOODS SOLD	=	**COST OF MERCHANDISE SOLD**

Illustration 5.19. Find out the cost of merchandise purchased, cost of merchandise sold, cost of merchandise unsold and Gross Profit from the following transactions:

	₹
Purchases (3,000 articles)	25,000
Freight	1,000
Local Taxes	1,000
Salaries	2,500
Shop Rent	500
Godown Rent	500
Electrical Charges	600
Municipal Taxes	200
Stationery	250
Furniture (estimated life 5 years)	12,000
Sales (2,700 articles)	32,000

Solution:

Particulars	*Amount ₹*
Cost of Merchandise purchased	
This consists of:	
Purchases	25,000
Freight	1,000
Local Taxes	1,000
	27,000
Cost of Merchandise sold	
Cost of 3,000 units of merchandise purchased	27,000
Cost of one unit of merchandise	9
Cost of 2,700 units of merchandise sold	24,300
Gross Profit	
Sales of 2,700 units of merchandise	32,000
Less: Cost of merchandise sold	24,300
	7,700
Cost of Merchandise unsold	
300 units @ ₹9 per unit	2,700

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All other expenses including annual depreciation of furniture (amounting in all to ₹6,950) will be considered for computing the Net Profit of the business. The concept of Net Profit has been explained later in the chapter.

Equation for Preparing Trading Account

On the basis of the Illustrations given in the preceding pages, the following equation can be derived for preparing Trading Account:

Gross Profit = Sales – Cost of Goods Sold

Cost of Goods Sold = Opening Stock + Purchases + Direct Expenses – Closing Stock

Therefore, Gross Profit = Sales – (Opening Stock + Purchases + Direct Expenses – Closing Stock)

Or **Gross Profit = (Sales + Closing Stock) – (Opening Stock + Purchases + Direct Expenses)**

The term "Direct Expenses" include those expenses which have been incurred in purchasing the goods, bringing them to the business premises and making them fit for sale. Examples of such expenses are carriage charges, octroi, import duty, expenses for seasoning the goods, etc.

The Trading Account can be prepared in the following form on the basis of equation given above.

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TRADING ACCOUNT

Dr. *for the period ending ...* *Cr.*

Particulars		*Amount* ₹	*Particulars*		*Amount* ₹
To Opening Stock		......	By Sales	......	
To Purchases	......		*Less:* Returns	......	......
Less: Returns	......	......	By Closing Stock		......
To Direct Expenses		......	By Gross Loss*		......
To Gross Profit*		......			......
		......			......

*Only one figure will be there.

Illustration 5.20. Prepare the Trading Account of Mr. Ramesh for the year ending 31st December, 2017 from the data as follows:

	₹		₹
Purchases	10,000	Wages	4,000
Purchases Returns	2,000	Carriage Charges	2,000
Sales	20,000	Stock on 1.1.2017	4,000
Sales Returns	5,000	Stock on 31.12.2017	6,000

Solution:

TRADING ACCOUNT

Dr. *for the year ending 31-12-2017* *Cr.*

Particulars		₹	*Particulars*		₹
To Opening Stock		4,000	By Sales	20,000	
To Purchases	10,000		*Less:* Sales		
Less: Returns	2,000	8,000	Returns	5,000	15,000
To Wages		4,000	By Closing Stock		6,000
To Carriage Charges		2,000			
To Gross Profit		3,000			
		21,000			21,000

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:

(i) Opening Stock (ii) Closing Stock

The term 'Opening Stock' 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.

The term 'Closing Stock' includes goods lying unsold with the businessman at the end of the accounting year. It should be noted that stock at the end of the accounting year is taken after the books of accounts have been closed. The following journal entry is passed in the Journal Proper to record the amount of closing stock:

Closing Stock Account Dr.

To Trading Account

The amount of closing stock is shown on the credit side of the Trading Account and as an asset in the Balance Sheet. This has been explained later. The Closing Stock at the end of the accounting period will become the Opening Stock for the next year. The Opening Stock is, therefore, shown on the debit side of the Trial Balance.

The following equations can be derived for computation of stocks:

Opening Stock = Cost of Goods Sold + Closing Stock – Cost of Purchases

Closing Stock = Opening stock + Cost of purchases – Cost of Goods Sold

Taking the figures from Illustration 5.6 the two stocks can be computed as under:

Opening Stock = Cost of Goods Sold + Closing stock – Cost of purchases

= 12,000 + 6,000 – 14,000 = ₹4,000

Closing Stock = Opening stock + Cost of purchases – Cost of Goods Sold

= 4,000 + 14,000 – 12,000 = ₹6,000

Valuation of Closing Stock: The closing stock is valued on the basis of "cost or market price whichever is less" principle. It is, therefore, very necessary that the cost of the goods lying unsold should be carefully determined. The market value of such goods will also be found out on the Balance Sheet date. The closing stock will be valued at the lower of the two values. For example, if the goods lying unsold at the end of the accounting period amount to ₹11,000, while their market price on the Balance Sheet date amounts to ₹10,000, the closing stock will be valued at ₹10,000. This valuation is done because of the accounting convention of conservatism, according to which expected losses are to be taken into account but not expected profits.

2. Purchases: The term "Purchases" includes both cash and credit purchases of goods. The term "goods", as already explained in an earlier chapter, means items 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. Similarly, purchase of articles such as stationery meant for using in the business will also not be included in the item of purchases. In case a proprietor has himself used certain goods for his personal purposes, the value of such goods at cost will be deducted from the purchases and included in the drawings of the proprietor. The journal entry in such a case would be as follows:

Drawings Account Dr.

To Purchases Account

Similarly, in case certain goods are given by way of free samples, etc., the value of such goods should be charged to advertisement account and deducted from purchases. The journal entry in such a case would be as follows:

Advertisement Account Dr.

To Purchases Account

The amount of purchases will be the net purchases made by the proprietor. The term 'net purchases' means total purchases of goods made by the businessman less the goods that he has returned back to the suppliers. In other words, purchases will be taken to the Trading Account after deducting purchases returns from the gross purchases made during the accounting period.

3. Sales: The term 'Sales' includes both cash and credit sales. Gross sales will be shown in the inner column of the Trading Account out of which "sales returns" will be deducted. The net sales will then be shown in the outer column of the Trading Account. Proper care should be taken in recording sale of those goods which have been sold at the end of the financial year but have not yet been delivered. The sales value of such goods should be included in the sales, but care should be taken that they are not included in the closing stock at the end of the accounting period.

Sales have to be recorded at net realisable value excluding sales tax, i.e., Sales excluding Sales Tax – Cost incurred necessarily to make the sale. For example, an item can be sold for ₹50 plus sales tax at 10% after getting it repaired at a cost of ₹5. The sales should be recorded at net relisable value, i.e., ₹45.

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 the Trading Account. Difficulty arises in those cases when the Trial Balance includes a single amount for "wages and salaries". In such a case, the amount is taken to the Trading Account. However, if the Trial Balance shows "salaries and wages" the amount is taken to the Profit and Loss Account. In actual practice such difficulties do not arise because the businessman knows for which purpose he has incurred the expenditure by way of wages or salaries. However, in an examination problem, it will be useful for the students to follow the principle given above, i.e., "wages and salaries" to be charged to Trading Account while "wages and salaries" to be charged to the Profit and Loss Account. Wages paid for purchase of an asset for long-term use in the business, i.e., wages paid for plant and machinery or wages paid for construction of a building should not be charged to the Wages Account. They should be charged to the concerned Asset Account.

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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: Freight, Carriage and Cartage 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 In", "Cartage In" and "Carriage In" have also the same meaning. However, "Cartage Out", "Freight Out" and "Carriage Out" are taken to be the expenses incurred on selling the goods. They are, therefore, charged to the Profit and Loss Account. The term "Inward" is also used for the term "IN". Similarly, the term "Outward" is also used for the term "Out". In other words, "Carriage" or "Carriage Inward" or ''Cariage In'' are used as synonymous terms. Similarly, ''Carriage Out'' or ''Carriage Outward'' are also synonymous terms. The same is true for other expenses like Freight or Cartage.

7. Royalty: Royalty is the amount paid to the owner for using his rights. For example, the royalty is paid by a "Lessee" of a coalmine to its owner for taking out the coal from the coalmine. Similarly, royalty is paid to the owner of a patent for using his right. It is generally taken as a direct expense and, therefore, is charged to the Trading Account. However, where royalty is based on sales, for example, in case of the book publishing trade, it may be charged to the Profit and Loss Account.

8. Gas, Electricity, Water, Fuel, etc. All these expenses are direct expenses and, therefore, they are charged to the Trading Account.

9. Packing Materials: Packing Materials used for packing the goods purchased for bringing them to the shop or convert them into a saleable state are direct expenses and, therefore, they are charged to the Trading Account. However, packing expenses incurred for making the product look attractive or packing expenses incurred after the product has been sold away are charged to the Profit and Loss Account.

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 and 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 Purchases Account is to be closed, the Purchases 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 debited.

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:

(i) Trading Account Dr.
To Stock Account (Opening)
To Purchases Account
To Sales Returns Account
To Carriage Account
To Customs Duty Account

(ii) Sales Account Dr.
Purchases Returns 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 and Loss Account.

Importance of the Trading Account

Trading Account provides the following information to a businessman regarding his business:

1. Gross Profit disclosed by the Trading Account tells him the upper limit within which he 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 largely by market factors over which he has no control. He can control only his operating expenses. For example, if the cost of purchasing an article is ₹10 and it can be sold in the market at ₹15 per unit, the gross margin available on each article is ₹5. In case a businessman proposes to sell 1,000 units of that article in a year, his gross profit or gross margin will be ₹5,000. His other expenses should therefore be less than ₹5,000 so that he can also save something for himself.
2. He can calculate his Gross Profit Ratio[2] and compare his performance year after year. A fall in the Gross Profit Ratio means increase in the cost of purchasing the goods or decrease in the selling price of the goods or both. In order to maintain at least same figure of gross profit in absolute terms, he will have to push up the sales or make all out efforts to obtain goods at cheaper prices. Thus, he can prevent at least fall in the figure of his gross profit if he cannot bring any increase in it.

2. Gross Profit ÷ Sales × 100

3. Comparison of stock figures of one period from another will help him in preventing unnecessary lock-up of funds in inventories.
4. In case of new products, the businessman can easily fix up the selling price of the products by adding to the cost of purchases, the percentage gross profit that he would like to maintain. For example, if the trader has been so far maintaining a rate of gross profit of 20% on sales and he introduces a new product in the market having a cost of ₹100, he should fix the selling price at ₹125 in order to maintain the same rate of gross profit (i.e., 20% on sales).

Check Your Progress

6. What is the term given to profit disclosed by the Trading Account?
7. State the principle on which the valuation of closing stock is done.

5.5 PROFIT AND LOSS ACCOUNT

The Trading Account simply tells about the gross profit or loss made by a businessman on purchasing and selling of goods. It does not take into account the other operating expenses incurred by him during the course of running the business. For example, he has to maintain an office for getting orders and executing them, taking policy decisions and implementing them. All such expenses are charged to the Profit and Loss Account. Besides this, a businessman may have other sources of income. For example, he may receive rent from some of his business properties. He may have invested surplus funds of the business in some securities. He might be getting interest or dividends from such investments. In order to ascertain the true profit or loss which the business has made during a particular period, it is necessary that all such expenses and incomes should be considered. Profit and Loss Account considers all such expenses and incomes and gives the net profit made or loss suffered by a business during a particular period. It is generally prepared in the following form:

PROFIT AND LOSS ACCOUNT

Dr. *for the year ending.....* *Cr.*

Particulars	₹	*Particulars*	₹
To Gross Loss b/d*	....	By Gross Profit b/d*	....
To Salaries	....	By Discount received	....
To Rent	....	By Net Loss transferred	
To Commission	....	to Capital A/c*	....
To Advertisements	....		
To Bad Debts	....		
To Discount	....		
To Net Profit Transferred			
to Capital Account*	....		
	....		....

* Only one figure of profit or loss will appear.

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Important Points Regarding Profit and Loss Account

1. **Gross Profit or Gross Loss** The figure of gross profit or gross loss is brought down from the Trading Account. Of course, there will be only one figure, *i.e.,* either of gross profit or gross loss.
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 and Loss Account. In case of a partnership firm, salaries may be allowed to the partners. Such salaries will also be charged to the Profit and 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 and 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. For example, if salaries paid are ₹2,400 after deducting income tax of ₹600, the amount of salaries to be charged to the Profit and Loss Account will be a sum of ₹3,000. The amount of tax-deducted at source by the employer, *i.e.*, ₹600 will be shown as a liability in the Balance Sheet.
4. **Salaries after deducting Provident Fund Contribution etc.** In order to provide for old age of the employees, employers contribute a certain percentage of salaries of the employees to the Provident Fund. The employee is also required generally to contribute an equivalent amount. The share of the employee's contribution to Provident Fund is deducted from the salary due to him and the net amount is paid to him. The amount of salaries to be charged to the Profit and Loss Account will be the gross salary payable to the employee, *i.e.*, including the employee's contribution to the Provident Fund. The contribution by the employer will also be charged as an expense to the Profit and Loss Account. Both employer's and employee's contributions to the Provident Fund will also be shown as liability in the Balance Sheet under the heading "Employees Provident Fund".
5. **Interest** Interest on loans whether short-term or long-term is an expense of an indirect nature and, therefore, is charged to the Profit and 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 and Loss Account.
6. **Commission** Commission may be both an item of income as well as an item of expense. 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 the Profit and Loss Account while commission received is credited to the Profit and Loss Account.

7. **Trade Expenses** Trade expenses 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 accounts for each of such types of expenses. The terms "Sundry Expenses", "Miscellaneous Expenses" or "Petty Expenses" have also the same meaning. They are charged to the Profit and Loss Account.
8. **Printing and Stationery** This item of expense includes expenses on printing of bills, invoices, registers, files, letter heads, ink, pencil, paper and other items of stationery, etc. It is of an indirect nature and, therefore, charged to the Profit and Loss Account.
9. **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 and Loss Account. However, advertisement expenses incurred for purchasing of goods should be charged to the Trading Account, while an advertisement expense incurred for purchase of a capital asset (*e.g.*, cost of insertion in a newspaper for purchase of car) should be taken as a capital expenditure and debited to the concerned asset account. Similarly, advertisement expenditure incurred for sale of a capital asset should be deducted out of the sale proceeds of the asset concerned.
10. **Bad Debts** Bad Debts denotes, the amount lost from debtors to whom the goods were sold on credit. It is a loss and, therefore, should be debited to the Profit and Loss Account.
11. **Depreciation** Depreciation denotes decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. For example, a motor car purchased gets depreciated on account of its constant use. A property purchased on lease for ₹12,000 for a period of 12 years will depreciate at the rate of ₹1,000 per year. On account of new inventions, old assets become obsolete and they have to be replaced. Mines etc. get exhausted after the minerals are completely taken out of them. An asset may meet an accident and may lose its value. It is necessary that depreciation on account of all these factors is charged to the Profit and Loss Account to ascertain the true profit or loss made by the business.
12. **Discount** It is a reduction from a list price, quoted price or invoice price. Discount may be of three types:
    (*a*) *Trade Discount* It is a reduction from the list price. It is a reduction granted by a supplier from the list price of goods or services.

(*b*) *Quantity Discount* It is similar to trade discount with the difference that it is given in case of purchasing of goods in bulk quantity.

(*c*) *Cash Discount* It is a reduction granted by a supplier from the invoice price in consideration of immediate payment or payment within a stipulated period.

Thus, quantity discount is similar to trade discount. However, cash discount is different from trade discount.

Distinction between trade discount and cash discount can be put as follows:

(*a*) *Meaning* A trade discount is a reduction granted by the supplier from the list price on total amount of sales, while a cash discount is a reduction for prompt payment or payment within a stipulated time period.

(*b*) *Objective* The objective of trade discount is to promote sales, while the objective of cash discount is quick collection of payment.

(*c*) *Time* Trade discount is allowed at the time of purchasing of goods, while cash discount is allowed at the time of making payment.

(*d*) *Disclosure* Trade discount is shown as reduction in the invoice itself, while cash discount is not shown in the invoice. Moreover, trade discount account is not opened in the ledger, while cash discount account is opened in the ledger.

(*e*) *Variation* Trade discount may vary with the quantity of goods purchased, while cash discount may vary with time period within which payment is received.

13. **Manager's Commissions** The manager of a firm may be given a certain percentage of net profit. This percentage of commission may be before or after charging of such commission. The computation of commission can be understood with the following example.

Example:

Net Profit before charging commision: ₹10,000.

Manager's Commission 10% of Net Profit before charging his commission.

The Manager's Commission can be computed as under:

$$= ₹10{,}000 \times \frac{10}{100}\ ₹1{,}000$$

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However, if the manager's commission is 10% of Net profit after charging his commission, the amount of commission will be computed as follows:

$$= ₹10,000 \times \frac{10}{100} ₹909$$

This can be verified as under:

Net Profit before charging commission	=	₹10,000
Less: Manager's Commission	=	₹909
Net Profit after charging commission	=	9,091

Thus, manager' commission of ₹909 is 10% of firm's net profits after charging commisson.

Accounting (Closing) Entries for Preparing Profit and Loss Account

The following journal entries will be passed in the Journal Proper for preparing the Profit and Loss Account.

(*i*) For transfer of items of expenses, losses, etc., appearing on the debit side of the Trial Balance

Profit and Loss Account	Dr.
To Salaries	
To Rent	
To Commission	
To Advertisements	
To Bad Debts	
To Discount	
To Printing and Stationery	

(*ii*) For transfer of items of incomes, gains, etc., appearing on the credit side of the Trial Balance

Interest Account	Dr.
Dividends Account	Dr.
Discount Account	Dr.
To Profit and Loss Account	

(*iii*) For transfer of net profit or net loss:

In case the total of the credit side of the Profit and Loss Account is greater than the debit side of the Profit and Loss Account, the difference is termed as Net Profit. In a reverse case, it will be termed as Net Loss. The amount of Net Profit or Net Loss shown by the Profit and Loss Account will be transferred to Capital Account in case of sole proprietary firm. In case of a partnership firm, the amount of net profit or net loss will be transferred to the Partners' Capital Accounts in the agreed ratio. In the absence of any agreement, the partners will share profits and losses equally.

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For transfer of Profit

Profit and Loss Account Dr.

To Capital Account(s)

For transfer of Net Loss

Capital Account(s) Dr.

To Profit and Loss Account

Illustration 5.21. From the following balances, taken from the Trial Balance of Shri Suresh, prepare a Trading and Profit and Loss Account for the year ending 31st Dec., 2017:

Particulars	*Dr.* ₹	*Cr.* ₹
Stock on 1.1.2017	2,000	
Purchases and Sales	20,000	30,000
Returns	2,000	1,000
Carriage	1,000	
Cartage	1,000	
Rent	1,000	
Interest Received		2,000
Salaries	2,000	
General Expenses	1,000	
Discount		500
Insurance	500	

The Closing Stock on 31st December, 2017 is ₹5,000.

Solution:

TRADING AND PROFIT AND LOSS ACCOUNT

Dr. *for the year ending 31st December, 2017* *Cr.*

Particulars		₹	*Particulars*		₹
To Opening Stock		2,000	BySales	30,000	
To Purchases	20,000		*Less:* Returns	2,000	28,000
Less: Returns	1,000	19,000	By Closing Stock		5,000
To Carriage		1,000			
To Cartage		1,000			
To Gross Profit c/d		10,000			
		33,000			33,000
To Rent		1,000	By Gross Profit b/d		10,000
To Salaries		2,000	By Interest		2,000
To General Expenses		1,000	By Discount		500
To Discount		1,000			
To Insurance		500			
To Net Profit taken to Capital Account		8,000			
		12,500			12,500

Importance of Profit and Loss Account

The Profit and Loss Account provides information regarding the following matters:

(*i*) **Ascertainment of net profit (or loss)** It provides information about the net profit or net loss earned or suffered by the business during a particular period. Thus, it is an index of the profitability or otherwise of the business.

(*ii*) **Comparative study** The Profit figure disclosed by the Profit and 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.

(*iii*) **Controlling expenses** An analysis of the various expenses included in the Profit and 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.

(*iv*) **Providing for contingencies** Allocation of profit among the different periods or setting aside a part of the profit for future contingencies can be done.

(*v*) **Prospective planning** On the basis for profit figures of the current and the previous period estimates about the profit in the year to come can be made. These projections will help the business in planning the future course of action.

Check Your Progress

8. State the entry for Salaries less Tax in the Profit and Loss Account.
9. What is the difference between cash discount and trade discount on account of disclosure?

5.6 BALANCE SHEET

Having prepared the Trading and Profit and Loss Account, a businessman will like to know the financial position of his business. For this purpose, he prepares a statement of his assets and liabilities as on a particular date. Such a statement is termed as ''Balance Sheet''. Thus, Balance Sheet is not an account but only a statement containing the assets and liabilities of a business on a particular date. It is, as a matter of fact, a classified summary of the various remaining accounts after accounts relating to Incomes and Expenses have been closed by transfer to Manufacturing, Trading and Profit and Loss Account.

Balance Sheet has two sides. On the left hand side, the ''liabilities'' of the business are shown while on the right hand side the assets of the business appear. These two terms have been explained later in the unit.

It will be useful here to quote definitions of the Balance Sheet given by some prominent writers. 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 Freeman, ''A Balance Sheet is an itemised list of the assets, liabilities and proprietorship of the business of an individual at a certain date." The definition given by the American Institute of Certified Public Accountants makes the meaning of Balance Sheet more clear. According to it, Balance Sheet is "a list of balances of the asset and liability accounts. This list depicts the position of assets and liabilities of a specific business at a specific point of time."

Proforma of Balance Sheet and Principle of Marshalling

Marshalling There is no prescribed form of Balance Sheet for a sole proprietary and partnership firm.[3] However, the principle of marshalling is applied while arranging the assets and liabilities in the balance sheet of a firm. Marshalling refers to arrangement of assets and liabilities in the balance sheet in any of the following order:

1. Liquidity Order   2. Permanency Order

1. **Liquidity Order** In case a concern adopts 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 first come first, and those payable later, come next and so on. A proforma of Balance Sheet according to liquidity order is given below:

BALANCE SHEET

as on ....

Liabilities	₹	*Assets*		₹
Bank Overdraft	....	Cash in Hand		....
Outstanding Expenses	....	Cash at Bank		....
Bills Payable	....	Prepaid Expenses		....
Sundry Creditors	....	Bills Receivable		....
Long-term Loans	....	Sundry Debtors		....
Capital	....	Closing Stock:		
		Raw Materials	....	
		Work-in-Progress	....	
		Finished Goods	....	....
		Plant and Machinery		....
		Furniture		....
		Building		....
		Land		....
		Goodwill		....
	....			....

2. **Permanency Order** In case of permanency order, assets which are more permanent come first, less permanent come next and so on. Similarly, liabilities which are more permanent come first, less permanent come next and so on. In other words, an asset which will be sold in the last or a liability which will be paid in the last come first and that order is followed both for all assets and liabilities. In case a balance sheet is to be prepared according to permanency order, arrangement of assets and liabilities will be reversed than what has been shown above in case of liquidity order.

3. In case of Joint Stock Companies the proforma of balance sheet has been prescribed by Schedule III (Part-I) of the Companies Act, 2013.

Distinction between Profit & Loss Account and Balance Sheet

The points of distinction between Profit & Loss Account and Balance Sheet are as under:

(*i*) A profit and loss account shows the profit or loss made by the business during a particular period. While a balance sheet shows the financial position of the business on a particular date.

(*ii*) A profit and loss account incorporates those items which are of a revenue nature while a balance sheet incorporates those items which are of a capital nature.

(*iii*) Of course, both profit and loss account and the balance sheet are prepared from the Trial Balance. However, the accounts transferred to the profit and loss account are finally closed while the accounts transferred to the balance sheet represent those accounts whose balances are to be carried forward to the next year.

Difference between Trial Balance and Balance Sheet

The difference between trial balance and balance sheet can be put as under:

(*a*) **Meaning** A trial balance is a statement containing various ledger balances on a particular date while a balance sheet is a statement of various assets and liabilities of the business on a particular date.

(*b*) **Objective** The objective of preparation of a trial balance is to check the arithmetical accuracy of the books of account of the business, while the objective of preparation of a balance sheet is to ascertain the financial position of the business.

(*c*) **Items covered** A trial balance contains all items relating to incomes, expenses, assets and liabilities while a balance sheet incorporates only assets and liabilities.

(*d*) **Preparation** A trial balance is prepared before preparation of a balance sheet. In other words, the preparation of a trial balance is independent of the preparation of a balance sheet. While a balance sheet is prepared not only on the basis of trial balance but also of any additional information which may not have been incorporated in the trial balance.

(*e*) **Use** A trial balance is meant only for internal use while a balance is prepared both for internal as well as external use.

Important Points Regarding Balance Sheet

1. **Liabilities** The term ‘‘Liabilities’’ denotes claims against the assets of a firm, whether those of owners of the business or of the creditors. As a matter of fact, the term “Equity” is more appropriate than the term “Liabilities”. This is supported by the definition given by American Accounting Association.

According to this Association, Liabilities are "claims of the creditors against the enterprise arising out of past activities that are to be satisfied by the disbursement or utilisation of corporate resources". While the term "Equity" stands both for owners equity (owners claims) as well as the outsiders equity (outsiders claims). However, for the sake of convenience, we are using the term "Liabilities" for the purposes of this book.

Liabilities can be classified into two categories:

(*i*) Current Liabilities (*ii*) Long-Term or Fixed Liabilities.

Current liabilities The term "Current Liabilities" 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. The broad categories of current liabilities are as follows:

(*a*) Accounts Payable, *i.e.*, bills payable and trade creditors.

(*b*) Outstanding Expenses, *i.e.,* expenses for which services have been received by the business but for which payments have not been made.

(*c*) Bank Overdraft.

(*d*) Short-term Loans, *i.e.*, loans from Bank which are payable within one year from the date of the Balance Sheet.

(*e*) Advance payments received by the business for the services to be rendered or goods to be supplied in future.

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

2. **Assets** The term ''Assets'' denotes the resources acquired by the business from the funds made available either by the owners of the business or others. It thus includes all rights or properties which a business owns. Cash, investments, bills receivable, debtors, stock of raw materials, work-in-progress and finished goods, land, buildings, machinery, trademarks, patent rights, etc., are some examples of assets.

Assets may be classified into the following categories:

(*a*) **Current assets** Current Assets are those assets which are acquired with the intention of converting them into cash during the normal business operations of the enterprise. According to Grady, ''the term Current Assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realised in cash or sold during the normal operating cycle of the business.''[4] Thus, the term "Current Assets" includes cash and bank balances, stocks of raw materials, work-in-progress and finished goods, debtors, bills receivable, short-term investments, prepaid expenses, etc.

4. Paul Grady, ''Inventory of Generally Accepted Accounting Principles for Business Enterprises'', pages 234-35.

(*b*) **Liquid assets** Liquid Assets are those assets which are immediately convertible into cash without much loss. Liquid Assets are a part of current asset. In computing liquid assets, stock of raw materials, work-in-progress and finished goods and prepaid expenses are excluded while all other current assets are taken.

(*c*) **Fixed assets** Fixed assets are those assets which are acquired for relatively long periods for carrying on the business of the enterprise. They are not meant for resale. Land and building, machinery, furniture are some of the examples of Fixed Assets. Sometimes, the term "Block Capital" is also used for them.

(*d*) **Intangible assets** Intangible Assets are those assets which cannot be seen and touched. Goodwill, patents, trademarks, etc., are some examples of Intangible Assets.

(*e*) **Fictitious assets** There are assets not represented by tangible possession or property. Examples of such assets are formation expenses incurred for establishing a business such as registration charge paid to the Registrar of joint stock companies for getting a company incorporated, discount on issue of shares, debit balance in the Profit and Loss Account when shown on the assets side in case of a joint stock company etc.

Valuation of Assets The following requirements of various accounting standards (ASs) should be kept in mind while valuing assets.

(*i*) The cost of a fixed asset should comprise its purchase price and any attributable costs of bringing the asset to its working condition for its intended use. (AS 10)

(*ii*) Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. (AS 10)

(*iii*) The direct costs incurred in developing the patents should be capitalised, and written off over their legal term of validity or over their working life, whichever is shorter. (AS 10)

(*iv*) Amount paid for knowhow for the plants, lay-out and designs of building and/or design of the machiery should be capitalised under the relevant asset heads, such as buildings, plants and machinery, etc., (AS 10)

(*v*) If the recoverable amount of an asset is less than its carrying amount, *i.e.*, it has become an impaired asset, the carrying amount of the asset should be reduced to its recoverable amount. That reduction is an impairment loss. Impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard. (AS 28)

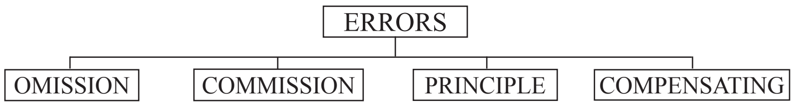
(*vi*) The current assets are meant for converting into cash during the normal operating cycle of business, hence, they are valued on the principle of ''cost or market price whichever is less''.

(*vii*) Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicates that the fundamental accounting assumption of going concern (*i.e.*, the continuance of existence or substratum of the enterprise) is not appropriate. (AS 4)

5.7 ERRORS: TYPES AND RECTIFICATION

Classification Of Errors

Errors can broadly be classified as clerical and those of principle.



Clerical errors may be of three kinds. These are explained here below.

I. Clerical Errors

These include the following errors:

1. **Errors of omission:** These errors are incurred in those cases when a transaction is completely omitted from the books of account. It happens when a transaction is not recorded in the books of the original entry (i.e., various journals). For example, if a purchase of goods on credit from Shri Ram Lal has not at all been recorded in the books of account, such an error will be termed as an error of omission. Since, there has been neither a debit entry nor a credit entry, therefore, the two sides of the Trial Balance will not be at all affected on account of this error. Such errors, therefore, cannot be located out very easily. They come to the notice of the businessman when statement of accounts are received from or sent to creditors or debtors, as the case may be.
2. **Errors of commission:** Such errors include errors on account of wrong balancing of an account, wrong posting, wrong carry forwards, wrong totalling, etc. For example, if a sum of ₹ 50 received from Mukesh is credited to his account as ₹ 500, this is an error of commission. Similarly, if the total of debit side of an account is carried forward from one page to another and the mistake is committed in such carry forward (e.g., total of ₹ 996 is carried forward as ₹ 699) such an error

is an error of commission. Errors of commission affect the agreement of the Trial Balance and, therefore, their location is easier.

3. **Errors of principle:** Errors of principle are committed, 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, or a capital receipt may have been taken as a revenue receipt or vice versa. For example, a sale of old furniture of ₹ 500 should be credited to the Furniture Account, but if it is credited to the Sales Account, it will be termed as an error of principle. Sale of old furniture is a capital receipt. If it is credited to Sales Account, it has been taken as a revenue receipt. Such errors by themselves do not affect the agreement of the Trial Balance. Therefore, they are also difficult to be located.
4. **Compensating errors:** As the name indicates, compensating errors are those errors which compensate each other. For example, if a sale of ₹ 500 to Ram is debited as only of ₹ 50 to his account, while a sale of ₹ 50 to Shyam is debited as of ₹ 500 to his account, it is a compensating error. These errors also do not affect the agreement of the Trial Balance and, therefore, their location is also difficult.

Thus, errors of omission, errors of principle and compensating errors by themselves alone do not affect the agreement of the Trial Balance. In case these errors get combined with errors of commission, they may affect the agreement of the Trial Balance. For example, if a sale of old furniture of ₹ 500 is credited to the Sales Account only as of ₹ 50, the error combines in itself both an error of principle as well as error of commission. Thus, such an error will affect the agreement of the Trial Balance.

Location Of Errors

Location of errors of principle, errors of compensating nature and errors of omission is slightly difficult because of the fact that such errors do not affect the agreement of the Trial Balance and, therefore, their location may be considerably delayed. However, location of errors of commission is comparatively easier because they affect the agreement of the Trial Balance. Thus, the errors can be classified into two categories from the point of view of locating them:

(i) Errors which do not affect the agreement of the Trial Balance.

(ii) Errors which affect the agreement of the Trial Balance.

Errors which do not affect the agreement of the trial balance: As stated before, errors of omission, errors of commission and errors of compensating nature by themselves do not affect the agreement of the Trial Balance. Their location is, therefore, 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.

For example, if a credit purchase of ₹ 500 from Ram has not been recorded in the books of accounts, the error will not affect the agreement of the Trial Balance and, therefore, at the time of finalising the accounts it may not be traced out. However, this will be found out when a statement of account is sent to Ram showing the money due to him or when a statement of account is received from Ram showing the money recoverable by him.

Errors which affect the agreement of 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 procedure to be followed for location of such errors can be put as follows:

(i) The difference of the two sides of the Trial Balance should be found out. The amount should then be divided by two. The two sides of the Trial Balance should then be checked to find out if there is an amount equal to that figure. It is possible that the amount was placed on a wrong side resulting in a difference in the totals of the Trial Balance. For example, if the total of the debit side of the Trial Balance is ₹ 450 more than the credit side of the Trial Balance, ₹ 450 should be divided by 2, thus giving a figure of 225. The debit side should then be checked to find out if there is an amount of ₹ 225 appearing on that side. If it is so, it should be seen whether the amount has been correctly put to that side or it should have gone to the credit side.

(ii) If the mistake is not found out by taking step number (i), the difference should be divided by 9. If the difference is completely divisible, it can be error of transposition of figures. For example, if the figure of 698 is written as 986, the difference is of ₹ 198. This figure is completely divisible by 9. Thus it can be concluded that in such cases where the difference is divisible by 9, there can be a probability of this type of error.

(iii) In case the difference is still not traceable, the following further possibilities should be checked:

  (a) If the difference is in a round figure, there is a possibility of wrong casting or wrong carry forwards of the totals of a subsidiary books or there is an error in balancing the accounts.

  (b) In case the difference is not in a round figure, there is a possibility of error being committed in posting the transactions from the Journal to the Ledger.

  (c) If the difference is of a substantial amount, it will be appropriate to compare the Trial Balance of the current year with the Trial Balance of the preceding year and see whether there is any abnormal difference between the balances of important accounts of the two Trial Balances.

(iv) Since, cash and bank account are not maintained usually in the Ledger, it will be also advisable to check whether the balances of the cash and bank accounts have been taken in the Trial Balance or not.

(v) The schedules of sundry debtors and sundry creditors should be checked to find out whether all balances of debtors and creditors have been included in these schedules or not.

(vi) The totals of the subsidiary books such as the Sales Book, Purchases Book should be checked and it should be seen whether posting has been done from these two books correctly to the Sales, Purchases or other accounts as the case might be.

(vii) If the error is still not traceable, check thoroughly the books of original entry and their posting into the Ledger and finally the balancing of different accounts.

(viii) A business may keep ledgers on sectional self-balancing system. In such a case, there are three ledgers: (a) Sales Ledger containing personal accounts of all trade debtors, (b) Purchases Ledger containing personal accounts of all trade creditors, and (c) General Ledger containing all other real, nominal and personal accounts except those of trade debtors and trade creditors. However, there will be two total accounts in this ledger. (i) Total Debtors Accounts, and (ii) Total Creditors Account. The balance of the Total Debtors Account should tally with the total of the Schedule of Debtors as prepared from the Sales Ledger. Similarly, the balance of the Total Creditors Account should tally with the total of the Schedule of Creditors as prepared from the Purchases Ledger. In case the balance of Total Debtors Account does not tally with the total of the Schedule of Debtors, the personal accounts in the Sales Ledger should be checked and the other Ledger may not be touched. Same is true of the Total Creditors Account and the Schedule of Total Creditors.

Suspense Account

The accountant should take the above-mentioned steps one after the other to locate the difference in the totals of the Trial Balance. In case he is not in position to locate the difference and he is in hurry to close the books of accounts, he may transfer the difference to an account known as "Suspense Account". Thus, Suspense Account is an account to which the difference in the Trial Balance has been put temporarily. On locating the errors in the beginning or during the course of the next year, suitable accounting entries are passed (as explained later) and the Suspense Account is closed. However, it should be noted that Suspense Account should be opened by the accountant only when he has failed to locate the errors in spite of his best efforts. It should not be by way of normal practice, because the very existence of the Suspense

Account creates doubt about the authenticity of the books of accounts. The result shown by the books of accounts may not be trusted by the proprietors, tax officials and other government authorities in such a case. This may create complications for the business.

Rectifying Accounting Entries

The errors committed in the books of accounts when located out, have to be corrected. However, corrections in the books of accounts should be done by passing proper rectifying entries and not by cutting or erasing figures. Such entries, as explained earlier, are passed in the General Journal or Journal Proper. The passing of proper rectifying entries is being explained below with suitable examples.

Example 1: The Sales Book overcast by ₹ 50.

Overcasting of Sales Book will result in over-credit to Sales Account by ₹ 50 since the total of the Sales Book is posted to the credit of the Sales Account at the end of a period. There can be two situations in such a case:

(i) The error might have been located out by the accountant before transferring the difference to the Suspense Account. In such a case, there is mistake only in one account, i.e., the Sales Account. It has been credited more by ₹ 50. The error can be rectified if the Sales Account is debited by ₹ 50. Thus, the following will be the rectifying entry in the Journal Proper:

Particulars	*Dr.* ₹	*Cr.* ₹
Sales Account *Dr.*	50	
(*Being excess credit to sales account, now rectified*)		

No account is to be credited since the error affects only one account.

(ii) The error might have been located out by the accountant after transferring the difference in the Trial Balance to a Suspense Account. In such a case two accounts are involved: (a) Sales Account, and (b) Suspense Account. Since Sales Account had been credited more by ₹ 50 the credit side of the Trial Balance must have been more than debit side of the Trial Balance. The Suspense Account should, therefore, have been put on the debit side of the Trial Balance in order to balance the two sides as shown below:

Trial Balance

Particulars	*Dr.* ₹	*Cr.* ₹
Excess Credit to Sales Account		50
Suspense Account	50	
	50	50

The Sales Account has been credited more by ₹ 50. In order to rectify the error, the Sales Account should, therefore, be debited by ₹ 50. Suspense Account has been debited because of this mistake which has now been found out. It should therefore, be closed by giving credit to it. The rectifying accounting entry should, therefore, be passed as follows:

Particulars	*Dr.* ₹	*Cr.* ₹
Sales Account *Dr.*	50	
To Suspense Account		50

Example 2: A credit sale of ₹ 100 to Ramesh has been entered in the Sales Book as a sale of ₹ 1,000.

In order to pass a rectifying entry, it will be appropriate to find out the accounts involved. In this case, the error involves two accounts: (i) Sales Account, and (ii) The account of Ramesh. This is because the posting is done in the individual accounts from the Sales Book and, therefore, if a transaction is wrongly recorded in the Sales Book (which is the book of original entry) not only the total of the Sales Book will be wrong, but also the entry in the personal account will be wrong as shown below:

Sales Book

Particulars	₹
Sales to Ramesh (wrongly recorded in place of ₹ 100)	1,000
Sales Account *Cr.*	1,000

Ledger

Dr. **Ramesh** *Cr.*

Particulars	₹	*Particulars*	₹
To Sales A/c	1,000		

Dr. **Sales Account** *Cr.*

Particulars	₹	*Particulars*	₹
		By Sundries (including sales to Ramesh)	1,000

The recording of the transactions as shown above shows that the Sales Account has been credited by ₹ 1,000 in place of ₹ 100. Similarly, the account of Ramesh has been debited by ₹ 1,000 in place of ₹ 100. Thus, Sales Account has been over-credited by ₹ 900, while the account of Ramesh has been over-debited by ₹ 900. In order to set the matters right, Sales Account should now be debited by ₹ 900 and the account of Ramesh should be credited by ₹ 900. The error should not have affected the agreement of the Trial Balance because of the same amount being put to the debit as well as the credit sides. The Suspense Account is, therefore, not at all involved.

NOTES

The rectifying accounting entry will, therefore, be as follows:

Particulars	Dr. ₹	Cr. ₹
Sales Account *Dr.*	900	
To Ramesh		900

Example 3: A sale of ₹ 50 to Suresh was posted to his account as a sale of ₹ 5.

In this case, the account of Suresh has been debited by only ₹ 5, in place of ₹ 50. His account has, therefore, been under-debited by ₹ 45. It means the credit side of the Trial Balance must have been more by ₹ 45 on account of this error. In case, the Suspense Account has been opened, it should have been debited by ₹ 45. The rectifying entry should, therefore, give debit of ₹ 45 to Suresh and give credit of ₹ 45 to Suspense Account. The entry will thus be as follows:

Particulars	Dr. ₹	Cr. ₹
Sales Account *Dr.*	45	
To Ramesh		45

The Suspense Account which was showing the debit balance of ₹ 45 would now be closed on account of passing of this rectifying entry.

Example 4: A sale of ₹ 50 to Kamlesh was entered in the Sales Book as of ₹ 500, from where he was debited by ₹ 5,000.

This is a multiple type of error. It affects more than two accounts. The accounts involved are (i) Kamlesh, (ii) Sales Account, and (iii) Suspense Account.

The total of the Sales Book is posted to the Sales Account. The sale has been recorded as of ₹ 500 in the Sales book from where the posting must have been done to the Sales Account. Thus, the Sales Account has been credited by ₹ 500 instead of ₹ 50. It has been credited more by ₹ 450. In order to rectify the error, it should, therefore, be debited by ₹ 450. The account of Kamlesh should have been debited by ₹ 50 only but it has been debited by ₹ 5,000. It has, therefore, been debited more by ₹ 4,950. In order to rectify the matters, it should be credited by ₹ 4,950. These two errors must have created difference in the Trial Balance which should have gone to the Suspense Account. Sales Account comes on the credit side of the Trial Balance. It has been credited by ₹ 450 more and, therefore, the credit side of the Trial Balance will be more by this amount on account of this error. On the other hand, Kamlesh is a debtor, his account has been excess debited by ₹ 4,950. The debit side of the Trial Balance should, therefore, be more by this amount. The net effect is that the debit side of the Trial Balance must have been more by ₹ 4,500 which must have been put to the Suspense Account by giving credit to it. The rectifying entry will, therefore, be as follows:

Particulars		Dr. ₹	Cr. ₹
Suspense A/c	Dr.	4,500	
Sales A/c Dr.		450	
To Kamlesh			4,950

Thus, on the basis of the above examples, the following rules can be framed out:

(i) Find out the accounts affected by the error.

(ii) Find out what should have been and what has been done.

(iii) Credit or Debit the respective account in order to set the matters right.

(iv) Put the difference to Suspense Account.

The above rules will be further clear by the following example.

Example 5: A sales of ₹ 1,000 to Suresh was entered in the Purchases Book from where the account of Suresh was debited by ₹ 100.

The above error affects the following accounts: (i) Sales Account, (ii) Purchases Account, and (iii) Account of Suresh.

Sales Account should have been credited by a sum of ₹ 1,000. It has not been done since it has been recorded in the Purchases Book. Thus, Sales Account should be credited (i.e., what should have been done).

Purchases Account has been debited since the transaction has been entered in the Purchases Book from where it must have been posted to the Purchases Account. It has been debited by a sum of ₹ 1,000 unnecessarily. It should, therefore, be credited to rectify what has been done wrongly.

Account of Suresh should have been debited by ₹ 1,000. In the normal course, since the transaction has been recorded in the Purchases Book, his account should have been credited. However, the accountant has debited his account by ₹ 100 instead of ₹ 1,000. His account should, therefore, be debited by ₹ 900 more in order to give full debit to his account.

The difference, if any, should be transferred to the Suspense Account as given in rule (iv) explained above.

The rectifying journal entry will, therefore, be as follows:

Particulars		Dr. ₹	Cr. ₹
Suspense A/c	Dr.	1,100	
Sales A/c Dr.		900	
To Purchases A/c			1,000
To Sales A/c			1,000

The comprehensive illustrations given in the following pages will further clarify the accounting entries required to be passed for rectification of different types of errors.

NOTES

Illustration 5.22: The total of debit side of the Trial Balance of Lotus Stores as at 31.03.2012 is ₹ 3,65,000 and that of the credit side is ₹ 2,26,000.

After checking, the following mistakes were discovered:

Items of Account	*Correct figures (as it should be) (₹)*	*Figures as it appears in the Trial Balance (₹)*
Opening Stock	15,000	10,000
Rent and rates	36,000	63,000
Sundry creditors	81,000	18,000
Sundry debtors	1,04,000	1,58,000

Ascertain the correct total of the Trial Balance.

Solution

Books of Lotus

Ascertainment of Correct Total of Trial Balance

as at 31.3.2012

	Dr. ₹	*Cr.* ₹
Total as per Trial Balance	3,65,000	2,26,000
Add: Opening stock understated	5,000	
	3,70,000	2,26,000
Less/Add: Adjustments Rent and rates overstated	(27,000)	
Sundry Creditors— understated		63,000
Sundry Debtors—Overstated	(54,000)	
Correct Total	2,89,000	2,89,000

Check Your Progress

10. Define marshalling.
11. What is the difference between Trial Balance and Balance Sheet on account of items covered?

5.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The two statements Income Statement and the Balance Sheet are termed as Final Accounts.
2. The Closing appears as the stock in the beginning of the accounting year and is credited in the Trading Account.
3. The Outstanding Salaries Account is a personal account representing the person to whom the salary has to be paid. It is, therefore, shown in the Balance Sheet on the liabilities side.

4. Although both accrued and outstanding incomes have been earned by the business and not yet received but in cased of accrued income, the income has not become due to the business while outstanding income is an income which has become due to the business.
5. When a provision for Discount on Debtors is provided, the following journal entry is passed:

   Discount A/c Dr.

   To Debtor's Personal A/c
6. The profit disclosed by the Trading Account is termed as Gross Profit.
7. The closing stock is valued on the basis of 'cost or market price which is less' principle.
8. In the case for Salaries less Tax entry in the Profit and Loss Account, the amount of gross salaries should be charged to the Profit and Loss Account, while the tax deducted by the employer will be shown as a liability in the Balance Sheet of the business till its is deposited with the Tax Authorities.
9. On account of disclosure, the trade discount is shown as reduction in the invoice itself, while cash discount is not shown in the invoice. Moreover, trade discount account is not opened in the ledger, while cash discount account is opened in the ledger.
10. Marshalling refers to arrangement of assets and liabilities in the balance sheet in any of the following order: liquidity order and permanency order.
11. The difference between Trial Balance and Balance Sheet on account of items covered is that a Trial Balance contains all items relating to incomes, expenses, assets and liabilities, while a balance sheet incorporates only assets and liabilities.

5.9 SUMMARY

- The accuracy of the books of accounts is determined by means of preparing a Trial Balance. Having determined the accuracy of the books of accounts every businessman is interested in knowing about two more facts. They are: (i) Whether he has earned a profit or suffered a loss during the period covered by the Trial Balance, (ii) Where does he stand now? In other words, what is his financial position?
- The determination of the Profit or Loss is done by preparing a Trading and Profit and Loss Account (or an Income Statement). While the financial position is judged by means of preparing a Balance Sheet of the business. The two statements together, i.e., Income Statement and the Balance Sheet, are termed as Final Accounts. As the term indicates,

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Final Accounts means accounts which are prepared at the final stage to give the financial position of the business.

- The following are the characteristics of Final Accounts: It is the final process of accounting, It is prepared to show the final result of the company in a specific period, It is the account, which is prepared at the end of the given year or period, it is also known as financial statement, it consists of trading account, profit and loss account and balance sheet, etc.
- The following are the main objectives of final accounts: To determine gross profit and net profit of the business during the year, to present the true financial position of the business on a given date, to make effective control on financial activities of the business, to make a summary presentation of all the financial transactions, to communicate the operating results and financial position of the users, and to help in making a different financial decision to the users of accounting information.
- 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.
- These adjustments usually relate to the following: Closing stock, outstanding expenses, prepaid expenses, outstanding or accrued income, income received in advance or unearned income, depreciation, bad debts, provision for bad debts, provision for discount on debtors, reserve for discount on creditors, interest on capital and interest on drawings.
- Trading Account gives the overall result of trading, i.e., purchasing and selling of goods. In other words, it explains whether purchasing of goods and selling them has 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.
- At the end of the accounting year, a trader may be left with certain unsold goods. Such stock of goods with a trader unsold at the end of the accounting period is termed as Closing Stock. Such a stock will become the opening stock for the next period.
- While calculating the amount of profit or loss on account of trading, a trader will have to take such Opening and Closing Stocks into consideration.
- A trader has to incur various types of expenses for purchasing of goods as well as for bringing them to his shop for sale. Such expenses may include brokerage or commission paid to agents for purchase of goods, cartage or carriage charges for bringing the goods to the trader’s

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shop, wages paid to coolies for transportation of goods etc. All such expenses increase the cost of the goods sold and hence they have also to be included in the cost of purchasing the goods.

- Cost of goods sold calculated as above will then be compared with the net sales to find out the amount of profit or loss made by the business.
- The term "Direct Expenses" include those expenses which have been incurred in purchasing the goods, bringing them to the business premises and making them fit for sale. Examples of such expenses are carriage charges, octroi, import duty, expenses for seasoning the goods, etc.
- Important things to be considered while preparing Trading Account are: stock, purchases, sales, wages, customs and import duty, freight, carriage and cartage, royalty and packing material, etc.
- 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 and Loss Account.
- The Trading Account simply tells about the gross profit or loss made by a businessman on purchasing and selling of goods. It does not take into account the other operating expenses incurred by him during the course of running the business.
- In order to ascertain the true profit or loss which the business has made during a particular period, it is necessary that all such expenses and incomes should be considered. Profit and Loss Account considers all such expenses and incomes and gives the net profit made or loss suffered by a business during a particular period.

5.10 KEY WORDS

- **Adjustment Entry:** A journal entry passed at the end of an accounting period to record the completed portion of an incomplete continuous event.
- **Profit & Loss Account:** An account presenting the revenues and expenses of an enterprise for an accounting period and shows the excess of revenues over expenses and *vice-versa.* It is also known as Income Statement.
- **Trading Account:** An account giving the overall result of trading, i.e., purchasing and selling of goods.
- **Assets:** It refers to tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.
- **Balance Sheet:** It refers to a statement of financial position of an enterprise as at a given period.

- **Current Assets:** It refers to cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business.
- **Current Liabilities:** It refers to liabilities payable within a year from the date of Balance Sheet either out of the existing current assets or by creation of new current liabilities.

5.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are final accounts? What purpose do they serve?
2. Differentiate between outstanding expense and prepaid expense.
3. What are bad debts? How are they included in the Final Accounts?
4. Write a short note on provision of discount to debtors and reserve for discount on creditors.
5. Explain the computation of interest on drawings.
6. What is merchandise?
7. List the equations required for preparing the Trading Account.
8. Explain the importance of Trading Account.
9. What are the important information provided by the Profit and Loss Account?
10. Distinguish between Profit and Loss Account and Balance Sheet.

Long Answer Questions

1. Discuss the characteristics and objectives of Final Accounts.
2. Why are adjustment entries required to be made at the time of preparing Final Accounts? Give illustrative examples of any four such adjustment entries.
3. Discuss the important points regarding Trading Account.
4. Examine the important points to be kept in mind while preparing a Profit and Loss Account.
5. Illustrate the different forms of Marshalling.
6. Discuss the differences between Trial Balance and Balance Sheet.
7. What are the important points regarding the preparation of Balance Sheet.

5.12 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

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BLOCK - II
FINANCIAL ACCOUNTING

NOTES

UNIT 6 BILLS OF EXCHANGE

Structure

6.0 INTRODUCTION

There are certain documents which are freely used in commercial transactions and monetary dealings. They are transferable by delivery and confer a good title on any one who takes them *bona fide* and for value. Such documents are termed as Negotiable Instruments. Bills of Exchange, Promissory Notes and Cheques are all Negotiable Instruments. These Instruments can be made "payable to order" or "payable to bearer." In the former case, they are known as "order instruments" while in the latter case they are known as "bearer instruments." In case of an order instrument the payment is to be made either to the person named in the instrument or according to his order. In case of a bearer instrument, the payment is to be made to the person who is its bearer. The provisions of the Negotiable Instruments Act, 1881 apply to them. We shall be discussing here only those legal provisions of the Act which shall enable the students to have a clear understanding of the accounting aspect of these instruments[1].

6.1 OBJECTIVES

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

- Discuss the fundamental concept of Bills of Exchange
- Explain the classification of Bills of Exchange

[1] For a detailed study of legal provision please refer to Sec IV: "*A Manual of Business Laws*" (6th edition) by Dr. S.N. Maheshwari and Dr. S.K. Maheshwari, and published by Himalaya Publishing House.

- Recall the concepts of acceptance of a bill and due date
- Describe the recording of Bill of Exchange in the book of Accounts

6.2 BILLS OF EXCHANGE: FUNDAMENTAL CONCEPTS

Let us analyse the fundamental concepts of bills of exchange.

6.2.1 Promissory Note

Definition Section 4 of the Negotiable Instruments Act defines a Promissory Note as "an instrument in writing (*not being a bank note and 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 or to the bearer of the instrument."

Essentials The following are essential features of a Promissory Note:

1. *There are two parties* The Promissor is termed as the Maker and the Promissee is called as the Payee. The former is the "Debtor" while the latter is the "Creditor".
2. *It is an instrument in writing* More verbal promise will not amount to a Promissory Note.
3. *The promise to pay should be unconditional* A promissory note should go without any condition attached to it. For example, *A* promises to pay a sum of money on the marriage of a particular person will not amount to a Promissory Note.
4. *The promise should be to pay money to another person* If a person promises to supply goods, it shall not be a Promissory Note.
5. *The amount should be certain* If interest is also to be paid, the rate of interest should be given.
6. The payee must also be certain, either by name or by designation.
7. A Promissory Note can be made payable to the bearer. However, a bearer Promissory Note cannot be drawn by private individuals. It can be drawn only by the Reserve Bank of India, as per the provisions of Section 31 of the Reserve Bank of India Act. The objective is to protect Government's monopoly of issuing currency notes.
8. Bank notes and currency notes, though similar to promissory notes in every respect, have been expressly excluded. They are considered as money and not merely securities for money. A currency note is a note issued by the Government containing a promise to pay to the bearer a certain sum of money on demand. A 'bank note' is a promissory note issued by a bank for payment of money to the bearer on demand. The

banks now cannot issue such notes which are payable to the bearer on demand on account of Section 31 of the Reserve Bank of India Act. Only the Reserve Bank of India is now authorised to issue such notes.

Specimen of a Promissory Note[2]

> **₹10,000**
>
> Delhi
> Jan. 4, 2016
>
> On demand,[2] I promise to pay Kaushal or order the sum of Ten thousand rupees, value received.
>
> (Stamp)
> sd/-
> Ramesh
>
> Ramesh is the Maker and Kaushal is the Payee.

6.2.2 Bill of Exchange

Definition Section 5 of the Negotiable Instruments Act defines a Bill of Exchange 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."

Essentials The essentials of a Bill of Exchange are similar to those of a Promissory Note except that:

1. In case of a Bill of Exchange, there are three parties, the "Maker" is termed as the "Drawer". He is the creditor. The person liable to pay the money is called as the "Drawee". The person entitled to get the money is termed as the "Payee". It should be noted that drawer himself can also be the payee. There are only two parties in case of a Promissory Note.
2. In case of a Bill of Exchange, the drawer being the creditor, orders the drawee to pay a certain sum of money; while in case of a Promissory Note, the drawer, being the debtor, himself, he promises to pay a certain sum of money.
3. A Time Bill of Exchange (*i.e.*, a B/E payable after some time) can be made payable to the bearer, while the Promissory Note cannot be made payable to the bearer by person other than the Reserve Bank of India or the Central Government.

6.2.3 Classification of Bills of Exchange

Bills of Exchange can be classified as follows:

1. *Time and demand bills* When payment of a Bill of Exchange is to be made after a particular period of time, the bill is termed as a 'Time Bill'. In such a case, date of maturity is always calculated by adding three

[2] In case of time promissory notes, the words 'on demand' will be instituted by words "..... months or ...... days after date or after sight."

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days of grace. Such bills requires the "Acceptance" of the drawee. It is generally given by writing across the face of the instrument as shown above:

In case of 'Demand Bill', payment is to be made on demand. Neither the acceptance of the drawee is necessary nor any days of grace are allowed in this case

Accepted
R. Mohan
1.1.2017

In case of 'Demand Bill', payment is to be made on demand. Neither the acceptance of the drawee is necessary nor any days of grace are allowed in this case.

2. *Trade and accommodation Bills* Where a Bill of Exchange has been drawn and accepted for a genuine trade transaction, it is termed as a 'Trade Bill'. For example, *A* sells goods worth ₹10,000 to *B*. He draws a Bill of Exchange on *B* for the said amount and the same is accepted by *B*. This is a Trade Bill. Where a Bill of Exchange is drawn and accepted for providing funds to a friend in need, it is termed as an Accommodation Bill. For example *C* may be in want of money. He may approach his friends *A* and *B*, who instead of lending the money directly to him, propose to draw an "Accommodation Bill" for ₹10,000 payable three months after, in his favour. *C* promises to reimburse *B* (the acceptor before the period of three months is up). *C* can get this bill discounted from his bankers. Thus, his needs of funds will be met.
3. *Inland and foreign bills* A Bill is termed as an Inland Bill, if
   (*a*) it is drawn in India on a person residing in India whether payable in or outside India, or
   (*b*) it is drawn in India on a person residing outside India but payable in India.

   A Bill which is not an Inland Bill is a Foreign Bill.

A Foreign Bill is generally drawn up in triplicate and each copy is sent by separate post, so that at least one copy reaches the concerned party. Of course, when payment is made on one copy, the other two copies become inoperative.

6.2.4 Cheque

Definition: Section 6 defines a cheque as 'A bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form'.

Essentials A cheque is similar to a bill of exchange with three additional qualifications:

1. It is always drawn on a specified banker.
2. It is always payable on demand.
3. It includes the electronic image of a truncated cheque and also a cheque in the electronic form. The two terms: 'A truncated cheque' and 'A cheque in the electronic form' having been defined under the Act as under:
   (*i*) 'A truncated cheque' means a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.
   (*ii*) 'A cheque in the electronic form' means a cheque which contains the exact mirror image of a paper cheque, and is generated, written and signed in a secure system ensuring the minimum safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system.

Thus, all cheques are bills of exchange but all bills of exchange are not cheques.

Check Your Progress

1. Define a promissory note.
2. How many parties are involved in a Bill of Exchange?

6.3 RECORDING OF TRANSACTIONS RELATING TO BILLS

Bills of Exchange and Promissory Notes, being Negotiable Instruments, are freely transferable. The transfer is made by endorsement and delivery in case of order instrument in case of non-payment of the bill, or promissory note can recover the money from all previous endorsers or the payee or the maker of the instrument. Moreover, the title of a holder-in due course remains good though the title of the transferrer may be defective. On account of these two important reasons, *i.e.*, negotiability and liability of the endorsers, a bill of exchange or a promissory note is considered to be an excellent security by the bankers. They are generally willing to advance money to a holder of bill of exchange or promissory note at commercial rate of discount. Thus, a person who receives a bill of exchange or promissory note has the following alternatives with him:

(*i*) He can keep the bill of exchange or promissory note with himself till the date of maturity.

(*ii*) He can pass it to one of his creditors.

(*iii*) He can get it discounted from his bank.

In the following pages, we are explaining the accounting entries to be made in the books of the receiver of a bill of Exchange or a Promissory Note (*i.e*., the Creditor or the Drawer or the Promisee in case or a Promissory Note) and the Acceptor (*i.e*., the Debtor, or the Drawee, or the Maker in case of a Promissory Note). For the former it is a Bill Receivable (the term is also used for a promissory note received) and for the latter, it is a Bill Payable (the term is also used for a promissory note given).

1. When a Bill of Exchange is Kept till the Date of Maturity

In case, the receiver of a bill of exchange keeps the Bill of Exchange till the date of maturity with him, the following accounting entries will be passed in the books of the receiver of the Bill of Exchange (*i.e*., the Drawer) and the Drawee of the Bill of Exchange.

In the Books of the Drawer:

(*i*) On selling goods on credit to the Drawee

Drawee	Dr.
To Sales A/c	

(*ii*) On receipt of Bill of Exchange duly accepted by the Drawee

Bill Receivable A/c	Dr.
To Drawee	

(*iii*) On receiving payment on maturity of the Bill

Cash A/c	Dr.
To Bills Receivable Account	

In the Books of the Drawee:

(*i*) On purchasing goods on credit from the Drawer

Purchases A/c	Dr.
To Drawer	

(*ii*) On acceptance of the Bill of Exchange in favour of Drawer

Drawer	Dr.
To Bills Payable Account	

(*iii*) On payment of the Bill on maturity

Bill Payable Account	Dr.
To Cash	

2. When the Bill of Exchange is Endorsed in Favour of a Creditor

In case the drawer of the Bill of Exchange endorses the Bill of Exchange received in favour of a creditor and the Bill is met on maturity, the following journal entries will be passed in the books of the Drawer as well as the Drawee of the Bill of Exchange.

Books of the Drawer

The entries regarding selling of goods and receiving of the Bills of Exchange will be the same, as explained before. However, the following entry will be passed when the Bill of Exchange is endorsed in favour of a Creditor.

Creditor A/c Dr.
  To Bills Receivable A/c

On the date of maturity, when the Bill is met, no entry is required in the books of the Drawer. This is because in his books, the Bills Receivable Account has already been closed and he has no liability, if the bill is met on maturity.

Books of the Drawee

The Drawee is not at all concerned with the endorsement of the Bill by the Drawer to a third-party. Accounting entries in his books will therefore be the same as explained before.

3. When Bill of Exchange is Discounted with a Bank

The Drawer of a Bill of Exchange may get the Bill of Exchange discounted from his bankers. In such a case, the following journal entries will be passed in the books of the Drawer and the Drawee.

Books of the Drawer

The entries regarding selling of goods and receipt of Bill of Exchange will be the same as explained before. However, the following entry will be passed in the books of the drawer when he gets the Bill of Exchange discounted from his bankers.

Bank Account	Dr.
Discount Account	Dr.
To Bills Receivable Account	

Books of the Drawee

The entries in the books of the Drawee will remain the same as explained before. He is not at all concerned whether he keeps the Bill with him or he gets it discounted from his bankers.

4. Dishonour of a Bill of Exchange

A Bill of Exchange is to be presented on maturity for payment. In case, the acceptor of the Bill refuses to make payment of the Bill on the date of maturity, it is said that the Bill of Exchange has been dishonoured. In order to get an authenticate proof of the fact that the Bill of Exchange was really presented for payment and was dishonoured, the Drawer (or holder) may get the Bill of Exchange noted and protested. The Notary Officer appointed by the Government for this purpose issues a certificate to this effect. He charges some fee for this work which is termed as "Noting Charges".

The entries for dishonour of the bill in the books of the Drawer (or holder) and the acceptor will be as follows:

Books of the Drawer

(*i*) If the Bill is kept by the Drawer (or the holder) with himself till the date of maturity:

On dishonour of the Bill

Drawee/Acceptor Dr.
To Bills Receivable A/c
To Cash A/c

(The account of the drawee or acceptor will be debited with the amount of the bill plus noting charges. The Bills Receivable Account will be credited with the amount of the Bill while Cash Account will be credited with the amount of the noting charges incurred.)

(*ii*) If the Bill is discounted with a banker and is dishonoured:

On dishonour of the Bill

Drawee/Acceptor Dr.
To Bank

(The account of the acceptor will be debited not only with the amount of the Bill but also with the amount of Noting Charges which the Bank might have paid. The account of the bank will be credited with the total amount.)

(*iii*) If the Bill is endorsed by the Drawer in favour of a Creditor and it is dishonoured:

On dishonour:

Drawee/Acceptor Dr.
To Creditors A/c

(The account of the drawee will be debited with the amount of the Bill as well as the amount of Noting Charges which the creditor might have incurred. The creditor will be given credit with the total amount.)

Books of the Acceptor

The acceptor will pass the following entry irrespective of the fact whether the Bill of Exchange is with the Drawer himself or it has been endorsed or discounted by him. He is concerned only with the Drawer and therefore, he is going to give him credit with the amount of the Bill plus any noting charges that might have been incurred either by him or by any other person who happens to be holder of the Bill of exchange.

Bills Payable A/c Dr.
Noting Charges Dr.
To Drawer

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5. Renewal of a Bill

The acceptor of the Bill may not be in a position to meet the Bill on the date of maturity. However, he may accept to meet the bill in case, he is given some time by the drawer for making payment of the Bill. He may, therefore, request the Drawer to cancel the old Bill and draw a new Bill on him.The Drawer may charge some interest for the delayed payment at mutually agreed rate of interest. The amount of interest may be paid in cash or it may be included in the amount of the new Bill. The following journal entries will be passed in the books of the Drawer and the Drawee on renewal of a Bill of Exchange.

Books of the Drawer

(*i*) Cancellation of the old Bill

Drawee's Personal A/c Dr.
To Bills Receivable A/c

(The entry is the same as for dishonour of a Bill of Exchange, except there will be no need for getting the Bill noted and protested, since the Drawee himself has requested for cancellation of the Bill.)

(*ii*) On receipt of amount of Interest in cash

Cash A/c Dr.
To Interest

(The interest will be charged for the delay in payment *i.e.*, the date by which the payment would be made as per the new Bill and the date by which payment should have been made as per the old Bill of Exchange.)

(*iii*) In case, the interest is not payable in cash

Drawee's Personal A/c Dr.
To Interest A/c

(*iv*) For receipt of the new Bill

Bills Receivable A/c Dr.
To Drawee's Personal A/c

(The amount will include the amount of interest also if it is not paid in cash.)

Books of the Drawee

(*i*) On cancellation of the old Bill:

Bills Payable A/c Dr.
To Drawer's Personal A/c

(The entry is similar to dishonour of the bill except that there will be no necessity for getting the bill noted and protested and, therefore, there will be no charge for Noting Charges.)

(*ii*) When Interest is paid in cash:

Interest A/c Dr.

To Cash A/c

(*iii*) In case the interest is not paid in cash:

Interest A/c Dr.

To Drawer's Personal A/c

(*iv*) On acceptance of the new Bill:

Drawer's Personal A/c Dr.

To Bills Payable A/c

(The amount may include the amount of interest if it has not been paid in cash.)

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6. Retiring of a Bill under Rebate

The acceptor of a Bill may be in a position to meet the Bill before maturity. He may, therefore, approach the acceptor to make the payment of the Bill before the due date of the Bill. In such a case, usually, the Drawer gives some rebate to the Drawer for early payment of the Bill. The following are the journal entries to be passed in the books of the Drawer as well as the acceptor.

Retiring of a Bill of Exchange which is with the Drawer

Books of the Drawer

On receipt of payment of the Bill

Cash A/c Dr.

Rebate A/c Dr.

To Bills Receivable A/c

(Rebate is a loss to the Drawer and, therefore, it is debited.)

Books of the Drawee

Bills Payable A/c Dr.

To Cash A/c

To Rebate A/c

(Rebate is a gain to Drawee and, therefore, it has been credited.)

Retiring of Bill of an Exchange Discounted or Endorsed by the Drawer

In case the acceptor requests the drawer to accept retirement of a bill which has been endorsed or discounted by the drawer, the drawer will have to request the bank or the creditor (endorsee) to return the bill back to him. He will then get the payment from the drawee and allow him rebate for pre-payment. Similarly, the bank or the creditor may also allow some rebate to the drawer on account of his making pre-payment to the bank or the creditor, as the case may be. The accounting entries will be as follows:

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In the Books of the Drawer

On return of the bill from bank/creditor

Bills Receivable A/c Dr.

To Bank/Creditor

On receiving payment from the drawee:

Cash A/c Dr.

Rebate Allowed A/c Dr.

To Bills Receivable A/c

On making payment to the Bank/Creditor:

Bank/Creditor A/c Dr.

To Cash A/c

To Rebate A/c

In the Books of the Drawee

The Drawee is concerned only with the Drawer. Hence, on payment of the bill under rebate, the entry will be the same as if the bill was with the Drawer, *i.e*.,

Bills Payable A/c Dr.

To Cash A/c

To Rebate A/c

The journal entries given in the preceding pages both in the Book of the Drawer of the Bill as well as the Acceptor of the Bill can be summarised as follows:

BOOKS OF THE DRAWER OF THE BILL

Sl. No.	*Transaction*	*Debit*	*Credit*
1.	On Selling of goods	Purchaser's A/c	Sales A/c
2.	On receipt of the Bill from the purchaser	Bill Receivable A/c	Purchaser's A/c
3.	Disposal of the Bill:		
	(*a*) When the Bill is kept by the receiver till the date of maturity.	No entry	No entry
	(*b*) When the Bill is discounted with a banker.	Bank A/c Discount A/c	 Bills Receivable A/c
	(*c*) When the Bill is endorsed in favour of a creditor.	Creditor's A/c	Bills Receivable A/c
4.	On maturity, if the Bill is honoured:		
	(*a*) If the Bill is kept by the receiver till the date of maturity.	Cash A/c	Bills Receivable A/c
	(*b*) If the Bill was discounted with the banker by the receiver.	No entry	No entry
	(*c*) If the Bill was endorsed in favour of a creditor.	No entry	No entry
5.	On maturity of the Bill, if dishonoured:		
	(*a*) If it is with the Drawer and he incurs Noting Charges.	Drawee's/Purchaser's A/c (Amount of the Bill + Noting charges)	Bills Receivable A/c (amount of the Bill) + Cash A/c (Noting Charges)

Sl. No.	Transaction	Debit	Credit
	(*b*) If the Bill was discounted and thereafter is now in the hands of the banker and noting charges are incurred	Drawee's A/c (with the amount of the Bill and Noting Charges)	Bank A/c (with the amount of the Bill and Noting Charges)
	(*c*) If the Bill was transferred to a Creditor and thereafter it is now in his hands and he incurs Noting Charges.	Drawee's A/c (with the amount of Bill and Noting Charges)	Creditor's A/c (with the amount of the Bill and Noting Charges)
6.	Renewal of the Bill:		
	(*i*) The entries will be similar to dishonour of the Bill except that there will be no expense by way of noting charges.		
	(*ii*) For interest paid in cash	Cash A/c	Interest A/c
	(*iii*) If interest not paid in cash	Drawee's A/c	Interest A/c
	(*iv*) For receipts of new bill	Bills Receivable A/c	Drawee's A/c
7.	Retirement of the Bill		
	(*i*) When the Bill is with the Drawer	Cash A/c, Rebate A/c	Bills Receivable A/c
	(*ii*) In case the Bill is with the Bank or with a creditor		
	(*a*) On return of Bill from bank/creditor	Bills Receivable A/c	Bank/Creditor's A/c
	(*b*) On receiving payment from the drawee	Cash A/c Rebate Allowed A/c	Bills Receivable A/c
	(*c*) On making payment to bank/creditor	Bank/Creditor A/c Rebate Received A/c	Cash A/c

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ENTRIES IN THE BOOKS OF THE DRAWEE OR ACCEPTOR OF THE BILL

Sl. No.	Transaction	Debit	Credit
1.	On purchases of goods	Purchases A/c	Seller's or the Drawer's A/c
2.	On acceptance of the Bill	Drawer's A/c	Bills Payable A/c
3.	On payment of the Bill	Bills Payable A/c	Cash A/c
4.	On dishonour of Bill and he has to bear the Noting Charges	Bills Payable A/c Noting Charges A/c	Drawer's A/c (amount of Bill plus Noting Charges)
5.	Renewal of the Bill		
	(*i*) Entry will be similar to dishonour of a Bill except there will be Noting Charges	Bills Payable A/c	Drawer's A/c
	(*ii*) (*a*) For interest paid in cash	Interest A/c	Cash a/c
	(*b*) For interest not paid in cash	Interest A/c	Drawer's A/c
	(*c*) For accepting new Bill	Drawer A/c	Bills Payable A/c
6.	On retirement of Bill	Bills Payable A/c	Cash A/c, Rebate A/c

Notes:

1. No entry is passed in the Acceptor's books for discounting or endorsing of bill of exchange by the Drawer/Receiver of the bill.
2. If the Drawee has transferred or got discounted the bill of exchange and the Bill is dishonoured, the Drawee will credit the account of the Drawer only and not any other account.

The comprehensive illustration given in the following pages will make clear to the readers the entries to be passed in the books of the Drawer as well as the Drawee of a bill of exchange.

Illustration 6.1. *A* sold goods to *B* for ₹5,000. *B* accepted two bills of ₹2,500 each for 2 months. *A* endorsed one bill to *C* for ₹2,600, on due date both the bills were met.

NOTES

Pass journal entries in the books of *A* and *B*.

Solution:

BOOKS OF *A*

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	B	Dr.		5,000	
	To Sales A/c				5,000
	(Being sale of goods to *B*)				
	Bills Receivable A/c	Dr.		5,000	
	To *B*				5,000
	(Being to Bills Receivable of ₹2,500 each received from *B*)				
	C	Dr.		2,600	
	To Bills Receivable A/c				2,500
	To Discount A/c				100
	(Being one Bill Receivable endorsed to *C*)				
	Bank A/c	Dr.		2,500	
	To Bills Receivable A/c				2,500
	(Being payment received of another Bill Receivable)				

BOOKS OF *B*

Date	Particulars			Dr. ₹	Cr. ₹
	Purchase A/c	Dr.		5,000	
	To *A*				5,000
	(Being goods purchased from *A*)				
	A	Dr.		5,000	
	To Bills Payable A/c				5,000
	(Being two acceptances of ₹2,500 each given to *A*)				
	Bills Payable A/c	Dr.		5,000	
	To Bank				5,000
	(Being acceptance met on maturity)				

Illustration 6.2. *A* owes to *B* ₹1,000. On 1st January, 2017, *A* accepts a three months' bill for ₹975 in full settlement. At the due date the Bill is dishnoured. Make journal entries in the books on both *A* and *B*.

Solution:

Books of *A*

JOURNAL

Date	Particulars		Dr. ₹	Cr. ₹
2017				
Jan. 1	*B*	Dr.	1,000	
	To Bills Payable A/c			975
	To Discount A/c			25
	(Bills Payable accepted in full settlement)			
April 4	Bills Payable A/c	Dr.	975	
	Discount A/c[3]	Dr.	25	
	To *B*			1,000
	(Bill Payable dishonoured)			

3. Please note that discount previously allowed has been disallowed.

NOTES

Books of *B*

JOURNAL

Date	Particulars		Dr. ₹	Cr. ₹
2017				
Jan. 1	Bills Receivable A/c	Dr.	975	
	Discount A/c	Dr.	25	
	To *A*			1,000
	(Bills Receivable received in full settlement)			
April 4	*A*	Dr.	1,000	
	To Bills Receivable A/c			975
	To Discount A/c[4]			25
	(Bill Receivable dishonoured)			

Illustration 6.3. Give necessary entries as would appear in *A*'s Books:

2017 May 5 *A* drew three bills on B for ₹500, ₹400 and ₹300 payable at 4, 3 and 2 months respectively.

May 12 He endorsed the first bill in favour of his customer *C* at ₹475.

May 19 He discounted the second bill with his banker for ₹380

May 26 He was paid the proceeds of the third bill at a rebate of 5% on the total amount of the bill.

On due dates the first and second bills were dishonoured but the third one was paid.

Solution:

JOURNAL

Date	Particulars		Dr. ₹	Cr. ₹
2017				
May 5	Bills Receivable A/c	Dr.	1,200	
	To *B*			1,200
	(Three Bills for ₹500, ₹400 and ₹300 were received from *B*)			
May 12	*C*	Dr.	475	
	Discount A/c	Dr.	25	
	To Bills Receivable A/c			500
	(The first bill for ₹500 was endorsed in favour of C for ₹475)			
May 19	Bank A/c	Dr.	380	
	Discount A/c	Dr.	20	
	To Bills Receivable A/c			400
	(The second bill for ₹400 was discounted with Bank)			
May 26	Bank A/c	Dr.	285	
	Rebate allowed A/c	Dr.	15	
	To Bills Receivable A/c			300
	(The third bill was retired at a rebate of 5% on the amount of the bill)			
Aug. 8	*B*	Dr.	400	
	To Bank A/c			400
	(The second bill dishonoured on maturity)			
Sept. 8	*B*	Dr.	500	
	To *C*			500
	(The first bill dishonoured on maturity)			

Note: The third bill has been paid before maturity and the entry for its payment has been passed on May 26.

Illustration 6.4. Sujesh owed money to Brijesh and hence accepted two bills each of ₹5,000 at three months duration drawn on him by the latter on

4 Please note that discount previously allowed has been disallowed.

NOTES

1st January, 2017. Brijesh discounted one of the bills with his bank for net proceeds of ₹4,800 and endorsed the other in favour of Mukesh to whom he owed a like sum, on the same date.

Sujesh paid the bill held by Mukesh on the due date, but failed to meet the bill presented by the bank. The bank debited Brijesh's account on 4th April, 2017 inclusive of bank charges of ₹10. Sujesh paid the amount inclusive of charges to Brijesh on 10th April, 2017.

Show the Journal entries in respect of the above in the books of Sujesh and Brijesh.

Solution:

JOURNAL OF SUJESH

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
2017				
Jan. 1	Brijesh	Dr.	10,000	
	To Bills Payable A/c			10,000
	(Being acceptance of two drafts of ₹5,000 each for three months)			
April 4	Bills Payable A/c	Dr.	5,000	
	To Cash A/c			5,000
	(Being honour of own acceptance at maturity)			
April 4	Bills Payable A/c	Dr.	5,000	
	Sundry Charges A/c	Dr.	10	
	To Brijesh			5,010
	(Being dishonour of own acceptance at maturity and sundry charges at ₹10 recoverable from us)			
April 10	Brijesh	Dr.	5,010	
	To Cash			5,010
	(Being discharge for the dishonoured acceptance)			

JOURNAL OF BRIJESH

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
2017				
Jan.1	Bills Receivable A/c	Dr.	10,000	
	To Sujesh			10,000
	(Being receipt of two acceptances of ₹5,000 each)			
Jan.1	Bank A/c	Dr.	4,800	
	Discount A/c	Dr.	200	
	To Bills Receivable A/c			5,000
	(Being discounting of one B/R with the banker)			
Jan. 1	Mukesh	Dr.	5,000	
	To Bills Receivable A/c			5,000
	(Being endorsement of another bill receivable)			
April 4	Sujesh	Dr.	5,010	
	To Bank			5,010
	(Being dishonour of discounted B/R and the extra liability to bank for bank charges of ₹10)			
April 4	Cash/Bank	Dr.	5,010	
	To Sujesh			5,010
	(Being receipt for the dishonoured acceptance)			

NOTES

Illustration 6.5. Bhasker Brothers are customers of *ABC* Ltd. The following are the details of invoices in respect of sales made by the latter to the former during the month of July, 2017.

Date	*Invoice No.*	*Value* ₹
1.7.2017	00212	20,000
4.7.2017	00224	21,412
9.7.2017	00344	14,210
17.7.2017	00433	17,230
25.7.2017	01820	21,630

ABC Ltd., drew bills of exchange for every sale payable at 30 days sight, and discount the bills at discounting charges of 1.5% p.m. You are required to show:-

(*a*) the entries in the Sales Day Book of *ABC* Ltd. for the above,

(*b*) the journal entries for drawing and discounting of bills on the respective days in the books of *ABC* Ltd., and

(*c*) Bhasker Brothers A/c in the ledger of *ABC* Ltd.

Solution:

SALES DAY BOOK OF *ABC* LTD.

Date	*Particulars*	*Outward Invoice No.*	*L. F.*	₹
2017				
July 1	Bhaskar Brothers	00212		20,000
July 4	Bhaskar Brothers	00224		21,412
July 9	Bhaskar Brothers	00344		14,210
July 17	Bhaskar Brothers	00433		17,230
July 25	Bhaskar Brothers	01820		21,630
				94,482

JOURNAL ENTRIES

Date	*Particulars*		*Debit*		*Credit*	
			₹	*P*	₹	*P*
2017						
July 1	Bill Receivable A/c	Dr.	20,000	00		
	To Bhaskar Brothers				20,000	00
	(Being receipts of bill of exchange No.1 payable at 30 days' sight for invoice No. 00212)					
	Bank A/c	Dr.	19,700	00		
	Discount A/c	Dr.	300	00		
	To Bill Receivable A/c				20,000	00
	(Being discounting of B/R No. 1 with Bank @1.5% p.m.)					
July 4	Bills Receivable A/c	Dr.	21,412	00		
	To Bhaskar Brothers				21,412	00
	(Being receipt of bill of exchange No. 2 for invoice No. 00224 payable at 30 days' sight)					
	Bank A/c	Dr.	21,090	82		
	Discount A/c	Dr.	321	18		
	To Bill Receivable A/c				21,412	00
	(Being discounting of B/R No. 2 with Bank @ 1.5% p.m.)					

NOTES

Date	Particulars		Debit ₹	Debit P	Credit ₹	Credit P
July 9	Bills Receivable A/c	Dr.	14,210	00		
	To Bhaskar Brothers				14,210	00
	(Being receipt of bill of exchange No. 3 payable at 30 days' sight for invoice No. 00433)					
	Bank A/c	Dr.	13,996	85		
	DiscountA/c	Dr.	213	15		
	To Bill Receivable A/c				14,210	00
	(Being discounting of B/R No. 3 with Bank @ 1.5% p.m.)					
July 17	Bills Receivable A/c	Dr.	17,230	00		
	To Bhaskar Brothers				17,230	00
	(Being receipt of bill of exchange No. 4 payable at 30 days' sight for invoice No. 00433)					
	Bank A/c	Dr.	16,971	55		
	Discount A/c	Dr.	258	45		
	To Bill Receivable A/c				17,230	00
	(Being discounting of Bills Receivable No. 4 with Bank @ 1.5% p.m.)					
July 25	Bill Receivable A/c	Dr.	21,630	00		
	To Bhaskar Brothers				21,630	00
	(Being receipt of bill of exchange No. 5 payable at 30 days' sight for the invoice No. 01820)					
	Bank A/c	Dr.	21,305	55		
	Discount A/c	Dr.	324	45		
	To Bill Receivable A/c				21,630	00
	(Being discounting of Bills Receivable No. 5 with Bank @ 1.5% p.m.)					

BHASKAR BROTHERS

Date	Particulars	₹	Date	Particulars	₹
2017			2017		
July 1	To Sales	20,000	July 1	By Bills Receivable (No.1)	20,000
July 4	To Sales	21,412	July 4	By Bills Receivable (No.2)	21,412
July 9	To Sales	14,210	July 9	By Bills Receivable (No.3)	14,210
July 17	To Sales	17,230	July 17	By Bills Receivable (No.4)	17,230
July 25	To Sales	21,630	July 25	By Bills Receivable (No.5)	21,630
		94,482			94,482

Check Your Progress

3. State two reasons why a bill of exchange or a promissory note is considered to be an excellent security by the bankers.
4. Mention the journal entries which are passed in the books of the drawer when the bill of exchange is discounted with a Bank.

6.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Promissory note is an instrument in writing (not being a bank note and 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 or to the bearer of the instrument.

2. In a Bill of Exchange, three parties are involved: the drawer, the drawee and the payee.
3. On account of two important reasons, negotiability and liability of the endorsers, a bill of exchange or a promissory note is considered to be an excellent security by the bankers.
4. The journal entries which are passed in the books of the drawer when the bill of exchange is discounted with a Bank are:

Bank Account	Dr.
Discount Account	Dr.
To Bills Receivable Account	

6.5 SUMMARY

- There are certain documents which are freely used in commercial transactions and monetary dealings. They are transferable by delivery and confer a good title on any one who takes them bona fide and for value. Such documents are termed as Negotiable Instruments. Bills of Exchange, Promissory Notes and Cheques are all Negotiable Instruments.
- Section 4 of the Negotiable Instruments Act defines a Promissory Note as "an instrument in writing (*not being a bank note and 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 or to the bearer of the instrument."
- Essential features of a Promissory Notes include: there are two parties, it is an instrument in writing, the promise to pay is unconditional, the promise should be to pay money to another person, the amount should be certain, the payee must also be certain, the promissory note can be made payable to the bearer, etc.
- Section 5 of the Negotiable Instruments Act defines a Bill of Exchange 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."
- The essentials of a Bill of Exchange are similar to that of a Promissory Note except that in case of a Bill of Exchange, there are three parties instead of two, the drawer is the creditor here instead of a debtor and that a Time Bill of Exchange can be made payable to the bearer unlike a Promissory Note which is only ordered by the Reserve Bank of India.
- Bill of Exchange can be classified as: Time and Demand Bills, Trade and Accommodation Bills and Inland and Foreign Bills.

NOTES

- Section 6 defines a cheque as 'A bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form'.
- Bills of Exchange and Promissory Notes, being Negotiable Instruments, are freely transferable. The transfer is made by endorsement and delivery in case of order instrument in case of non-payment of the bill, or promissory note can recover the money from all previous endorsers or the payee or the maker of the instrument.
- A person who receives a bill of exchange or promissory note has the following alternatives with him:
  - (i) He can keep the bill of exchange or promissory note with himself till the date of maturity.
  - (ii) He can pass it to one of his creditors.
  - (iii) He can get it discounted from his bank.

  There are different journal entries in the books of the receiver and the Acceptor depending on the transaction.

6.6 KEY WORDS

- **Accommodation Bill:** A bill drawn and accepted for providing funds to a friend in need.
- **Bill of Exchange:** An instrument in writing containing an unconditional order signed by the maker, directing the said 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.
- **Cheque:** A bill of exchange drawn on a specified banker and payable on demand.
- **Demand Bill:** A bill of exchange payable on demand.
- **Promissory Note:** An instrument in writing, containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of certain person or the bearer of the instrument.
- **Time Bill:** A bill of exchange payable after a particular period of time.
- **Trade Bill:** A bill drawn and accepted for a genuine trade transaction.

6.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Differentiate between a Bill of Exchange and a Promissory Note.
2. Write a short note on trade bill and accommodation bill.

3. What are time bills and demand bills?
4. Differentiate between retiring a bill and renewal of a bill.

Long Answer Questions

NOTES

1. Describe the essential features of a Promissory Note.
2. How are Bills of Exchange classified?
3. Give a specimen with atleast five entries of the following:
   (a) A Bills Receivable Book
   (b) A Bills Payable Book

   You are also required to make the posting of these entries in the ledger.
4. Explain the dishonour of a bill of exchange with the entries.

6.8 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

Jain, S.P. and Narang, K.L. 2001. *Advanced Accountancy*. New Delhi: Kalyani Publishers.

Ahmed, N. 2008. *Financial Accounting*. New Delhi: Atlantic Publishers and Distributors Pvt. Ltd.

UNIT 7 ACCOUNT CURRENT AND AVERAGE DUE DATE

NOTES

Structure

7.0 INTRODUCTION

The technique of average due date is also useful for calculating interest on drawings made by the proprietors or partners of a business firm at several points of time. The due date of a bill of exchange is the date when the amount of a bill/invoice is payable by the drawee/ creditor to drawer/ debtor.

7.1 OBJECTIVES

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

- Understand the concepts of Account Current and Average Due Date
- Appreciate the purpose of preparing Account Current
- Explain the utility of Average Due Date
- Make computation of interest for preparing Account Current
- Prepare Account Current

7.2 ACCOUNT CURRENT: MEANING, ADVANTAGES AND CALCULATION

In case there are several transactions between two parties, it will be necessary to take into account the question of interest besides ensuring the correctness of amount due by one party to the other. It will be appropriate in such a case that each party should send a Statement of Account to the other party instead of settling each transaction individually. Such a statement when rendered in the form of an account by one party to another, duly setting out in chronological order the details of the transactions together with interest, is termed as an Account Current. The main heading of the account is preceded by the name of the party to whom it is rendered and is succeeded by the name of the party sending the statement. For example, if *A* sends an account current to *B*, the heading of the account current will be:

B in account current with *A*

In case the account current is being sent by *B* to *A*, the heading of the account current will be:

A in account current with *B*

Account current is sent by one person to another in case of the following types of relationship:

(a) Principal and Agent, (b) Consignor and Consignee, (c) Supplier of goods and Customer, and (d) Co-venturers.

NOTES

7.2.1 Computation of Interest

Interest is usually calculated on the basis of number of days. Thus, computation of interest involves:

(1) Calculation of days.

(2) Calculation of the amount of interest.

(1) Calculation of days: The following points should be kept in mind while calculating the number of days.

(i) There are three methods for calculating the number of days:

(a) *Forward method:* The method is most common. The number of days is calculated from the due date of the transaction to the date of settlement.

(b) *Backward or epoque method:* In case of this method the number of days is counted from the opening date (the date of commencement) of the account current to the due date of the transaction.

(c) *Daily balance method:* The method is used by banks. Days are calculated from the due date of a transaction to the due date of the next transaction.

(ii) The effective date of the transaction should be considered for calculating the number of days irrespective of the method followed. For example, if, as per terms of trade, some credit period is allowed, any interest is to be charged only with effect from the date after the expiry of such a period. Similarly, when bills of exchange are received or issued, the due date of the bill (including 3 days of grace) will be the effective date for this purpose.

(iii) The date of the transaction should be excluded while calculating the number of days. For example, if days are to be calculated from 5th January, 1999 (the date of transaction) to 31st January, 1999 (settlement date), the number of days will be taken as 26, the day of 5th January will be excluded.

NOTES

(iv) In case some balance has been brought forward from the previous period, the first day of the new period will also be considered. For example, if there has been a opening balance on 1st March and when the settlement date is considered 30th June, the number of days will be counted as follows:

March 31 + April 30 + May 31 + June 30 = 122

However, if a new transaction takes place on 1st March, the day of 1st March will not be included for calculating the number of days.

(2) Calculation of amount of interest: There are four methods for charging interest:

(i) *Calculating interest on each item:* In case of this method interest is calculated on each item separately. The days are calculated from the date of the transaction to the settlement date and interest is charged for the number of days so calculated at a agreed rate of interest.

Illustration 7.1: The following are a series of transactions between *A* and *B* for the three months ending on 31st March 2015. Calculate the amount of interest to be payable by one party to the other @ 10% p.a.

	Books of A	₹
Jan. 1	Opening balance (*Dr.*)	5,000
Jan. 10	Sold goods to *B*	10,000
Jan. 15	Cash received from *B*	10,000
Feb. 15	Sold goods to *B*	10,000
March 1	Cash received from *B*	5,000

Solution

B* in Account Current with *A

Date	*Particulars*	₹	*Date*	*Particulars*	₹
Jan. 1	To Balance b/d	5,000	Jan. 15	By Cash	10,000
Jan. 10	To Sales	10,000	March 1	By Cash	5,000
Feb. 15	To Sales	10,000	March 31	By Balance c/d	10,217
March 31	To Interest (*see Working Note*)	217			
		25,217			25,217

Working Note:

Computation of Interest

Debit Items	₹	*Credit Items*	₹
(i) 5,000 × (90/365) × (10/100)	123	(i) 10,000 × (75/365) × (10/100)	206
(ii) 10,000 × (80/365) × (10/100)	220	(ii) 5,000 × (30/365) × (10/100)	41
(iii) 10,000 × (44/365) × (10/100)	121		

Total Interest to be charged to *B* = (123 + 220 + 121) – (206 + 41) = ₹ 217

(ii) *Product method:* This is a modification of the first method. In place of making separate calculations, the amount involved in each transaction is multiplied by the number of days (or months) from its date to the date of settlement. Interest is calculated on the balance of the products for one day (or month) and is put on the side the sum of the products is more. However, if the rates of interest are different for debits and credits, interest for debits and credits will have to be calculated separately.

Illustration 7.2: With the figures given in the Illustration 7.1, calculate the amount of interest according to the Product Method.

(*For Solution please see page 199*)

Red Ink Interest

Sometimes, the due date of a transaction falls after the closing date of the account current. For example, an account current is prepared for the quarter ending 31st March, 2015. *A* receives a bill of exchange from *B* for ₹ 10,000 on 15th March due one month after date. The due date of the transaction is, therefore, 18th April, 2015, i.e., 18 days after the closing date of the account current. *A* on 31st March is entitled to get interest from *B* for 18 days instead of allowing interest to him for this transaction. In the statement to be rendered by *A* to *B*, the product of 1,80,000 will be subtracted from the total of the products of other items. In order to differentiate it from other products, the products of such an amount is entered in **red ink**. This is the reason why such a product is known as "red ink interest" product.

Illustration 7.3: From the following transactions in the books of *X*, prepare an account current to be sent by *X* to *Y* from the quarter ending 31st March, charging and allowing interest at 12% p.a.

		₹
Jan. 1	Balance in *Y*'s account (*Dr.*)	3,000
Jan. 14	Sold goods to *Y*	5,000
Feb. 11	Cash received from *Y*	4,000
Feb. 17	Sold goods to *Y*	3,000
Feb. 19	Received a bill of exchange from *Y* due two months after date	5,000

(*For Solution please see page 199*)

(iii) *Epoque method:* This method is the reverse of the first two methods. Interest is computed from the opening date of the account current to the date of each transaction. Thus, no interest is charged on the opening balance while interest for the whole period will be charged on the closing balance.

Interest is calculated at the agreed rate on the balance of the products for one day (or month) and entered on the side which has smaller product. In case rates of interest are different for debits and credits, interest for each side will have to be calculated separately.

Solution (Illustration 7.2)

B* in Account Current with *A

Date	*Particulars*	*Amount*	*Days*	*Product*	*Date*	*Particulars*	*Amount*	*Days*	*Product*
Jan. 1	To Balance b/d	5,000	90	4,50,000	Jan. 15	By Cash	10,000	75	7,50,000
Jan. 10	To Sales	10,000	80	8,00,000	Mar. 1	By Cash	5,000	30	1,50,000
Feb. 15	To Sales	10,000	44	4,40,000	Mar. 31	By Balance of Products			7,90,000
Mar. 31	To Int. on balance of products for one day $\frac{7,90,000\times10}{100\times365}$	217			Mar.31	By Balance c/d	10,217		
		25,217		16,90,000			25,217		16,90,000

Solution (Illustration 7.3)

Books of *A*

Y* in Account Current with *X

Date	*Particulars*	*Amount*	*Days*	*Product*	*Date*	*Particulars*	*Amount*	*Days*	*Product*
Jan.	To Balance b/d	3,000	90	2,70,000	Feb. 11	By Bank	4,000	48	1,92,000
Jan. 14	To Sales	5,000	76	3,80,000	Feb. 19*	By B/R due on April 22	5,000	22	(1,10,000)
Feb. 17	To Sales	3,000	42	1,26,000	Mar. 31	By Balance of Products			6,84,000
Mar. 31	To Interest $\frac{6,84,000\times12}{100\times365}$	225			Mar. 31	By Balance c/d	2,225		
		11,225		7,76,000			11,225		7,76,000

* To be in red ink.

Illustration 7.4: With the figures given in the Illustration 7.1, calculate the amount of interest according to Epoque method.

(For Solution please see page 198)

NOTES

(iv) *Periodical balance method:* The method is usually followed in banks. The balance is struck after each transaction and is multiplied by the number of days up to the next transaction. Interest is charged for one day on the difference of the products. In case the rates of interest are different for debits and credits interest will be calculated for the debits of the products and the credits of the products separately. The difference of the two amounts will be the amount of interest chargeable to or receivable from the party concerned.

Illustration 7.5: Suneel opened a current account with New Bank of India on 1st January 2015. The details of the transactions for the quarter ending 31st March, 2015 are as follows:

		₹
Jan. 1	Deposited	10,000
Jan. 15	Deposited	5,000
Feb. 12	Deposited	10,000
Feb. 15	Withdraw	30,000
Mar. 10	Withdraw	5,000

The bank allow interest on credit balance at 2% p.a., while it charges on debit balances at 10% p.a.

Prepare Suneel's account in the Bank's ledger.

(*For Solution please see page 198*)

Illustration 7.6: From, the following particulars prepare a current account, as sent by Mr. Ram to Mr. Siva as on 31st October, 2014 by means of product method charging interest @ 5% p.a.

2014	*Particulars*	₹
1st July	Balance due from Siva	750
15th August	Sold goods to Siva	1250
20th August	Goods returned by Siva	200
22nd Sep	Siva paid by cheque	800
15th Oct	Received cash from Siva	500

Solution

Siva in Account Current with Ram

Dr. *as on 31st Oct, 2014* *Cr.*

Date	*Particulars*	₹	*Days*	*Product (₹)*	*Date*	*Particulars*	₹	*Days*	*Product (₹)*
01.07.14	To Bal. b/d	750	123	92,250	20.08.14	By Sales Returns	200	72	14,400
15.8.14	To Sales	1,250	77	96,250	22.09.14	By Bank	800	39	31,200

NOTES

Date	Particulars	₹	Days	Product (₹)	Date	Particulars	₹	Days	Product (₹)
31.10.14	To Interest	18.48			15.10.14	By Cash	500	16	8,000
						By Balance of Products			1,34,900
					31.10.14	By Bal. c/d	518.18		
		2018.48		1,88,500			2018.48		1,88.500

Interest $= ₹\, 1{,}34{,}900 \times \frac{5}{100} \times \frac{1}{365} = ₹ 18.48$

Illustration 7.7: Roshan has a current account with partnership firm. It has debit balance of ₹ 75,000 as on 01-07-2017. He has further deposited the following amounts:

Date	*Amount (₹)*
14-07-2017	1,38,000
18-08-2017	22,000

He withdrew the following amounts:

Date	*Amount (₹)*
29-07-2017	97,000
09-09-2017	11,000

Show Roshan's Account in the ledger of the firm. Interest is to be calculated at 10% on debit balance and 8% on credit balance. You are required to prepare current account as on 30th September, 2017.

Roshan's Current Account with Partnership Firm

(as on 30.9.2017)

Date	Particulars	Dr (₹)	Cr (₹)	Balance (₹)	Dr. or Cr.	Days	Dr. Product (₹)	Cr. Product (₹)
01.07.17	To Bal b/d	75,000		75,000	Dr.	13	9,75,000	
14.07.17	By Cash A/c		1,38,000	63,000	Cr.	15		9,45,000
29.07.17	To Self	97,000		34,000	Dr.	20	6,80,000	
18.08.17	By Cash A/c		22,000	12,000	Dr.	22	2,64,000	
09.09.17	To Self	11,000		23,000	Dr.	22	5,06,000	
30.09.17	To Interest A/c	457		23,457	Dr.			
30.09.17	By Bal. c/d		23,457					
		1,83,457	1,83,457				24,25,000	9,45,000

Interest Calculation:

On ₹ 24,25,000 × 10% × 1/365 = ₹ 664

On ₹ 9,45,000 × 8% × 1/365 = ₹ 207

Net interest to be debited = ₹ 457

Note: The above current account has been prepared by means of product of balances method.

NOTES

Solution (Illustration 7.4)

B* in Account Current with *A

Date	*Particulars*	*Amount*	*Days*	*Product*	*Date*	*Particulars*	*Amount*	*Days*	*Product*
		₹					₹		
Jan. 1	To Balance b/d	5,000	–	–	Jan. 15	By Cash	10,000	15	1,50,000
Jan. 10	To Sales	10,000	10	1,00,000	Mar. 1	By Cash	5,000	60	3,00,000
Feb. 15	To Sales	10,000	46	4,60,000	Mar. 31	By Balance (excluding Int.)	10,000	90	9,00,000
Mar. 31	To Balance of Products			7,90,000	Mar. 31	By Balance (including Int.)	10,217		
Mar. 31	To Interest: $\frac{7,90,000 \times 10}{100 \times 365}$	217							
		25,217		13,50,000			25,217		13,50,000

Solution (Illustration 7.5)

Suneel in Account Current with New Bank of India

Date	*Particulars*	*Dr.*	*Cr.*	*Dr. or Cr.*	*Balance*	*Days*	*Dr. Product*	*Cr. Product*
2015								
Jan. 1	By Cash		10,000	*Cr.*	10,000	14		1,40,000
Jan. 15	By Cash		5,000	*Cr.*	15,000	28		4,20,000
Feb. 12	By Cash		10,000	*Cr.*	25,000	3		75,000
Feb. 15	To Self	30,000		*Dr.*	5,000	23	1,15,000	
Mar. 10	To Self	5,000		*Dr.*	10,000	21	2,10,000	
Mar. 31	To Interest	54		*Dr.*	10,054			
		35,054	25,000				3,25,000	6,35,000
April 1	To Balance b/d			*Dr.*	10,054			

Note: ₹ 10,000 was deposited on January 1, 2015. The next deposit was on January 15. Thus, interest on ₹ 10,000 should be allowed for 14 days. Similarly on 15th there was another deposit of ₹ 5,000. The next deposit was on February 12. Thus, interest for 28 days should be allowed on ₹ 15,000. The total of credit column of the product is 6,35,000. While that of debit is 3,25,000. Interest to be charged is ₹ 89 [i.e., (3,25,000 /365) × (10/100)] while interest to be allowed is ₹ 35 [i.e., (6,35,000/365) ×(10/100) × 2 × 1]. Thus, the net under to be charged is a sum of ₹ 54.

7.3 AVERAGE DUE DATE

NOTES

Average Due Date may be defined as the mean or equated date on which one payment may be made in lieu of several payments due on different dates without loss of interest to either party. For example, *A*, a businessman, may have a series of transactions involving receipts and payments of money due on different dates with *B*, another businessman. They may decide to settle their accounts on a particular date, after taking into account the amount of interest which may have become due by one party to another. There are two alternatives available in such a case:

(a) Interest may be calculated separately for each transaction, or

(b) A mean date may be determined and the interest may be calculated from such mean date to the date of actual settlement on the total amount due by one party to another.

Alternative (b) is preferable since it will reduce a lot of clerical work. The mean date so calculated is termed as the Average Due Date.

Utility of Average Due Date

Average due date is useful in the following types of accounting problems:

1. Problems relating to settlement of accounts involving a series of bills of exchange due on different dates.
2. Problems relating to calculation of interest of partners' drawings made on different dates.
3. Problems involving piecemeal realisation of assets during the partnership dissolution.
4. Problems involving settlement of accounts where money advanced is to be received in a number of instalments due on different dates.

Types of Problems

Broadly, the problems relating to computation of the Average Due Date can be put into two categories:

(i) Calculation of Average Due Date when the amount is lent in a number of instalments and repayment is made in one instalment.

(ii) Calculation of Average Due date when the amount is lent in one instalment and repayment is made in a number of instalments.

Each of these types of problems has been exhaustively explained in the following pages.

(i) Where the amount is lent in a number of instalments: The calculation of the Average Due Date in this case can be done by taking the following steps:

1. A certain convenient basic date (or zero date) is taken as a starting point. This is usually the date of one of the transactions and preferably the due date of the first transaction.
2. In respect of each transaction, the number of days (or months) filling in between the basic date and date of the transaction is ascertained.
3. The amount of the transaction is multiplied by the number of days (or months) ascertained by step 2 above.
4. Both the products as ascertained by step 3 above as well as the amounts are added up.
5. The total of the products is divided by the sum total of the amount.
6. The result is the number of days (or months) by which the Average Due Date is distant from the chosen date. In other words, the basic date + number of days (or months), calculated in this way, will give Average Due Date.

NOTES

In case some amounts have been paid out and some have been received, the products for the two should be added up separately. The difference between the two totals of the products should then be divided by the difference in the sum total of the amounts of Debit and Credit. However, it should be noted that the basic date for both groups of transactions should be the same.

Calculation of interest: The computation of the Average Due Date simplifies interest calculations. The amount of interest can be calculated from the Average Due Date to the date of settlement instead of making separate calculation for interest for each transaction. This will be clear with the help of the following illustration:

Illustration 7.8: Sunil is a partner in Sunil & Sharad Co. His drawings from the business during the year 2014 are as follows:

Month	₹	*Month*	₹
Jan. 31	150	Jul. 31	250
Feb. 28	100	Aug. 31	150
Mar. 31	160	Sep. 30	120
Apr. 30	200	Oct. 31	100
May. 31	140	Nov. 30	180
June 30	70	Dec. 31	300

You are required to calculate the Average Due Date and the amount of interest @ 10% p.a. payable by Sunil for his transactions, taking

(a) Jan. 1 as the basic date,

(b) Dec. 31 as the basic date.

NOTES

Solution

Month	Dec. 31 being used as basic date			Jan. 1 being used as basic date	
	Amount ₹	Months before 31st Dec.	Product	Months after 1st Jan.	Product
2014					
Jan. 31	150	11	1,650	1	150
Feb. 28	100	10	1,000	2	200
Mar. 31	160	9	1,440	3	480
Apr. 30	200	8	1,600	4	800
May 31	140	7	980	5	700
June 30	70	6	420	6	420
July 31	250	5	1,250	7	1,750
Aug. 31	150	4	600	8	1,200
Sep. 30	120	3	360	9	1,080
Oct. 31	100	2	200	10	1,000
Nov. 30	180	1	180	11	1,980
Dec. 31	300	0	0	12	3,600
	1,920		9,680		13,360

Average Due Date when December 31 is taken as the basic date = 9,680/1,920 = 5 months (approx.) prior to 31st December.

Hence, the Average Due Date is 31st July.

Average Due Date when January 1st is taken as the basic date = 13,360/1,920 = 7 months (approx.) subsequent to January 1.

Hence, the Average Due Date is 31st July.

In case Sunil had paid the amount of ₹ 1,920 to the firm on the Average Due Date, i.e., 31st July, there would have been no loss of interest to either party. Since the accounts are being settled not on 31st July but on 31st December, Sunil is liable to pay to the firm interest for 5 months. The amount comes to $\left(1{,}920 \times \frac{10}{100} \times \frac{5}{12}\right)$ = ₹ 80.

(ii) Where the amount is lent in a single instalment In this case, where the amount is lent in one single instalment while the repayment is made in a number of equal instalments, the average due date can be calculated by taking the following steps:

1. The number of days (months or years) from the date of lending money to the date of each repayment should be calculated.
2. The total of such days (months or years) should be found out.
3. The total calculated as per step 2 above should be divided by the number of instalments payable for repayment of the amount.
4. The result as per step 3 above will be the number of days (months or years) by which the Average Due Date is away from the date on which the loan was given.

The above steps for calculation of the Average Due Date can be put in the form of the following formula:

$$ADD = D + \frac{SDP}{N}$$

where ADD = Average Due Date

D = Date of lending

SDP = Sum of Days (months or years) from the date of lending to the date of repayment of each instalment.

N = Number of instalments.

Illustration 7.9: ₹ 10,000 lent on 1st January, 2012 is repayable in 5 equal annual instalments commencing from 1st January, 2012. Find the Average Due Date.

Solution

$$ADD = D + \frac{SDP}{N}$$

where ADD = Average Due Date

D = Date of lending (1st January, 2012)

SDP = Sum number of years from 1st Jan. 2012 to the repayment of each instalment.

N = Number of instalments.

ADD = 1st Jan. 2012 + $\frac{(1+2+3+4+5)}{5}$ years

= 1st January, 2012 + 3 yrs

= 1st January, 2015

Illustration 7.10: Mr X lends ₹ 1,000 to Kumar Bros. on 1st January, 2013. The amount is repayable in 5 half-yearly equal instalments commencing from 1st January, 2014.

Calculate the Average Due Date and interest at 10% p.a.

Solution

In order to calculate the Average Due Date, the sum of period from the date of lending to the date of each transaction will have to be calculated.

1st payment is made after	12	months from the date of lending.
2nd payment is made after	18	months from the date of lending.
3rd payment is made after	24	months from the date of lending.
4th payment is made after	30	months from the date of lending.
5th payment is made after	36	months from the date of lending
Total	120	

$$ADD = D + \frac{SDP}{N}$$
$$= \text{1st Jan. 2013} + \frac{120}{5} \text{ months}$$
$$= \text{1st Jan. 2013} + 24 \text{ months}$$
$$= \text{1st Jan. 2015.}$$

NOTES

If Mr *X* had lent the money on 1st January, 2015 and when Kumar Bros. pay back the money as per the above schedule, there would have been no loss of interest to either party. Since *X* lent money to Kumar Bros. on 1st January, 2013, 2 years earlier to 1st Jan. 2015, he is entitled to get interest for this period of two years from Kumar Bros.

The amount of interest has been calculated as follows:

$$\frac{1,000 \times 10 \times 2}{100} = ₹\,200$$

Illustration 7.11: Ramkumar, having accepted the following bills drawn by his creditor Prakash Chand due on different dates, approached his creditor to cancel them all and allow him to accept a single bill for the payment of his entire liability on the average due date.

You are requested to ascertain the total amount of the bill and its due date.

Bill No.	*Date of Drawing*	*Date of Acceptance*	*Amount of the Bill (₹)*	*Tenor*
1.	16.2.2015	20.2.2015	8,000	90 days after sight
2.	6.3.2015	7.3.2015	6,000	2 months after date
3.	24.5.2015	31.5.2015	2,000	4 months after sight
4.	1.6.2015	4.6.2015	9,000	1 month after date

Solution

Computation of Average Due Date

Starting Date = 23.5.2015 (The date when the first bill is due for payment)

Bill No.	*Due date* 1	*Amount ₹* 2	*No of days from the starting date (23.5.2000)* 3	*Product* 4 = (2 × 3)
1.	23.05.2015	8,000	0	0
2.	09.05.2015	6,000	(–)14	(–)84,000
3.	03.10.2015	2,000	133	2,66,000
4.	04.07.2015	9,000	42	3,78,000
	Total	25,000		5,60,000

Average Due Date = $23.5.2015 + \frac{5,60,000}{25,000} = 23.5.2015 + 22$ days (approx.) = 14.6.2015.

Thus, if payment is to be affected on the basis of average due date, the total amount of the single bill shall be ₹ 25,000 due on 14.6.2015.

Notes:

(i) Starting date is also known as 'basic date' or 'zero date'. This is usually taken on basis of the due date of the first transaction. There is, however, no harm if some other day is chosen for the purpose.

(ii) Due dates of the individual bills are calculated after taking 3 days of grace into consideration.

NOTES

Illustration 7.12: M/s Stairs & Co. draw upon M/s Marble & Co. several bills of exchange due for payment on different dates as under:

Date of Bill	*Amount (₹)*	*Tenure of Bill*
12th May	44,000	3 months
10th June	45,000	4 months
1st July	14,000	1 month
19th July	17,000	2 months

Find out the average due date on which payment may be made in one single amount by M/s Marble & Co. to M/s Stairs & Co. 15th August, Independence Day, is national holiday and 22nd September declared emergency holiday, due to death of a national leader.

Solution

Calculation of Average Due Date

(Taking 4th August as the base date)

Date of Bill	*Term*	*Due Date*	*Amount* ₹	*No. of days from the base date, i.e., 4th August*	*Product*
12th May	3 months	14th August	44,000	10	4,40,000
10th June	4 months	13th October	45,000	70	31,50,000
1st July	1 month	4th August	14,000	0	0
19th July	2 months	23rd September	17,000	50	8,50,000
			1,20,000		44,40,000

Average due date= Base date + Days equal to $\frac{\text{Total of products}}{\text{Total amount}}$

$$= \text{4th August} + \frac{44,40,000}{1,20,000}$$

= 4th August + 37 days = 10th September

Illustration 7.13: Kishanlal has made the following sales to Babulal. He allows a credit period of 10 days beyond which he charges interest @ 12% per annum.

Date of Sales	*Amount (₹)*
26.05.14	12,000
18.07.14	18,000
02.08.14	16,500
28.08.14	9,500
09.09.14	15,500
17.09.14	13,500

NOTES

Babulal wants to settle his accounts on 30-9-2014. Calculate the interest payable by him using Average Due Date (ADD). If Babulal wants to save interest of ₹ 588, how many days before 30.9.2014 does he have to make payment? Also find the payment date in this case.

Solution

Computation of Average Due date

(Taking 05th June as the base date)

Date	*Due Date*	*Amount* ₹	*No. of days from Base date*	*Product* ₹
26.05.2014	05.06.2014	12,000	0	0
18.07.2014	28.07.2014	18,000	53	9,54,000
02.08.2014	12.08.2014	16,500	68	11,22,000
28.08.2014	07.09.2014	9,500	94	8,93,000
09.09.2014	19.09.2014	15,500	106	16,43,000
17.09.2014	27.09.2014	13,500	114	15,39,000
		85,000		61,51,000

$$\text{Average due date} = 5.6.14 + \frac{61{,}51{,}000}{85{,}000}$$

= 5.6.14 + 72 days (app.) = 16.08.2014

Interest if settlement is done on 30.9.14

$$85{,}000 \times 12\% \times \frac{45}{365} = ₹\ 1{,}258 \text{ (approx.)}$$

If Babulal wants to save interest of ₹ 588, then the calculation of days before 30.09.2014 will be:

588/1258 × 45 days (16.08.2014 to 30.09.2014) = 21 days earlier

Payment date in the above case will be 09.09.2014.

Check Your Progress

1. State the two components of computation of interest.
2. What is backward or epoque method?
3. What are the two alternatives of average due date method?

7.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Interest is usually calculated on the basis of number of days. Thus, computation of interest involves:
   - Calculation of days.
   - Calculation of the amount of interest.
2. In case of Backward or epoque method the number of days is counted from the opening date (the date of commencement) of the account current to the due date of the transaction.

NOTES

3. The two alternatives of average due date method are:
   (a) Interest may be calculated separately for each transaction, or
   (b) A mean date may be determined and the interest may be calculated from such mean date to the date of actual settlement on the total amount due by one party to another.

   Alternative (b) is preferable since it will reduce a lot of clerical work. The mean date so calculated is termed as the Average Due Date.

7.5 SUMMARY

- In case there are several transactions between two parties, it will be necessary to take into account the question of interest besides ensuring the correctness of amount due by one party to the other. It will be appropriate in such a case that each party should send a statement of account to the other party instead of settling each transaction individually.
- Such a statement when rendered in the form of an account by one party to another, duly setting out in chronological order the details of the transactions together with interest, is termed as an Account Current.
- Interest is usually calculated on the basis of number of days. Thus, computation of interest involves:
  - o Calculation of days.
  - o Calculation of the amount of interest.
- Average Due Date may be defined as the mean or equated date on which one payment may be made in lieu of several payments due on different dates without loss of interest to either party.
- Average due date is useful in the following types of accounting problems:
  - o Problems relating to settlement of accounts involving a series of bills of exchange due on different dates.
  - o Problems relating to calculation of interest of partners' drawings made on different dates.
  - o Problems involving piecemeal realisation of assets during the partnership dissolution.
  - o Problems involving settlement of accounts where money advanced is to be received in a number of instalments due on different dates.
- The computation of the Average Due Date simplifies interest calculations. The amount of interest can be calculated from the Average Due Date to the date of settlement instead of making separate calculation for interest for each transaction.

NOTES

7.6 KEY WORDS

- **Account current:** An account rendered by one party to another duly setting out in chronological order the details of the transactions together with interest and the ultimate balance due by one party to another.
- **Average due date:** A mean or equated date on which one payment may be made in lieu of several payments due on different dates, without loss of interest to either party.
- **Zero date:** A certain convenient basic date which is taken as the starting point for computing the average due date.

7.7 SELF ASSESSMENT QUESTION AND EXERCISES

Short Answer Questions

1. What is meant by 'Red-Ink Interest' in an Account Current?
2. What is Joint Venture?
3. Differentiate between
    (a) Forward Method and Backward Method in Account Current.
    (b) Account Current and Current Account.
    (c) Average Due Date and the Date of Settlement.

Long Answer Questions

1. Define an Account Current. Explain the different methods for computing interest.
2. What is an Average Due Date? Explain the various steps that are to be taken for computation of an Average Due Date.

7.8 FURTHER READINGS

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UNIT 8 BANK RECONCILIATION STATEMENT

NOTES

Structure

8.0 INTRODUCTION

In this unit, you will learn about Bank Reconciliation Statement, which is a summary of banking and business activity that reconciles an entity's bank account with its financial records. The statement outlines the deposits, withdrawals and other activity affecting a bank account for a specific period. Bank reconciliation statements ensure payments have been processed and cash collections have been deposited into the bank. The reconciliation statement helps identify differences between the bank balance and book balance, in order to process necessary adjustments or corrections. An accountant typically processes reconciliation statements once a month. Completing a bank reconciliation statement requires using both the current and the previous month's statements, including the closing balance of the account.

8.1 OBJECTIVES

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

- Identify the advantages to the business firm by keeping an account with the bank
- Describe the meaning of bank reconciliation statement
- Discuss the reasons for difference in bank reconciliation statement
- Explain the importance of bank reconciliation statement
- Examine the procedure for preparing bank reconciliation statement

8.2 MEANING, NEED AND PROCEDURE OF RECONCILIATION

NOTES

While explaining recordings of cash transactions in an earlier chapter, it has already been stated that a firm may keep account(s) with one or more banks. The advantages of keeping an account with a bank are as follows:

1. **Avoidance of risk** Keeping large cash balances in the office is risky. In case money is deposited from time to time in the bank such risk can be avoided.

2. **Prevention of fraud and misappropriation** Deposits of money into the bank and disbursing them through the bank reduces the chances of fraudulent activities and misappropriation of funds by the employees of the firm. All receipts can immediately be deposited at the end of the day in the bank. Similarly, all payments can be made by means of cheques. Thus, the quantum of cash to be handled by the employees of the business is considerably reduced, resulting in lesser chances of fraud and misappropriation.

3. **Reduction in accounting work** Depositing money into the bank and making payments through a bank considerably reduces the firm's accounting work. As a matter of fact, in case of large business houses or institutions, the banks open extension counters where all payments can be received and made. Thus, the accounting work at the firm's level is considerably reduced since the firm's cash accounting work is more or less done by the bank.

When money is deposited by the firm 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 (*i.e.*, 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. The above rules of accounting as regards bank transactions can be summarised as follows:

(*i*) On deposits of money by the firm into the bank account, the firm debits the bank account while the bank credits the firm's account.

(*ii*) On withdrawal of money by the firm from the bank, the firm credits the bank's account while the bank debits the firm's account.

Thus, the balance as shown by the firm's books in the bank account should tally with the balance shown by the bank's books 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; the vice versa is the otherwise case. However, the two balances rarely tally on account of the reasons given later in the unit.

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 maintains the firm's account in its books. A copy of this account is submitted to the firm from time to time. The account so submitted by the bank to the customer is known as the bank pass book or bank statement. A proforma of one page of bank pass book is given below:

State Bank of India
SAVINGS BANK ACCOUNT
.... Branch
Name of the Depositor(s)...................................... Account No..............
Address...

Date	*Cheque No./ Pay-in Slip*	*Particulars*	*Debit ₹*	*Credit ₹*	*Balance ₹*	*Initials*

The Pass Book or the Bank Statement is submitted by the bank to the customer for his information and verification. As already stated the balance shown by the bank column of the cash book and the bank pass book normally do not tally on account of certain reasons. These reasons are being explained in the following pages.

8.2.1 Reasons for Difference between Cash Book and Passbook Balances

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.

1. **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 books in the firm's account will be higher than the balance shown by the firm's books in the bank account. For example, a firm issues a cheque in favour of a creditor on 28th December, 2010 for a sum of ₹10,000. The cheque is presented by

the creditor on 3rd January, 2011 for payment. In case the bank submits a statement of account to the firm upto 31st December, 2010, there will be a difference of ₹10,000 between the balance as shown by the firm's books and the balance as shown by the pass book.

2. **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. For example, if a firm sends a cheque of ₹5,000 on 25th December, 2010 to the bank for collection which is collected by the bank on 5th January, 2011, in the statement of account which may be submitted by the bank for the year ending 31st December, 2010, there will be no credit to the customer for the cheque which it has not yet collected. Thus, the balance shown by the firm's cash book will be different from the balance as shown by the bank pass book.

3. **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.

4. **Direct collections on behalf of customers:** A banker may receive amounts due to the customer directly from customer's debtors. For example, the banker may get dividends, rents, interest, etc. directly from the persons concerned on account of standing instructions of the customer to such persons. The bank gives credit to the customer for such collections as soon as it gets such payments. However, the customer comes to know of such collections only when he receives the statement of account from his banker. Thus, the balance shown by the bank pass book and the one shown by the firm's cash book may not be the same on account of this reason.

5. **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.

8.2.2 Meaning and Importance of Bank Reconciliation Statement

A Bank Reconciliation Statement is a statement reconciling the balance as shown by the bank pass book and the balance as shown by the cash book. The objective of preparing such a statement is to know the causes of difference between the two balances and pass necessary correcting or adjusting entries in the books of the firm. It should be noted that every variation or difference does not require an adjusting or correcting entry. Some reasons for difference are automatically adjusted. For example, a cheque that has been sent for collection, but not yet collected, causes a difference between the balance as shown by the bank pass book and the balance as shown by the cash book, but no adjusting entry is required in the cash book for such a difference because, the bank will credit the firm's account as soon as the cheque is collected. This is only a question of time. However, if the cheque sent for collection to the bank has been returned by the bank on account of it being dishonoured, the firm should pass an adjusting entry for return of this cheque if it has not already been passed. Similarly, the firm has also to pass in its books the entries for bank charges or direct payments received by the bank on behalf of the firm.

Importance of Bank Reconciliation Statement

The importance of Bank Reconciliation Statement can be judged on the basis of the following facts:

(*i*) It highlights the causes of difference between the bank balance as per cash book and the bank balance as per pass book. Necessary adjustments or corrections can therefore be carried out at the earliest.

(*ii*) 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.

(*iii*) There is a moral check on the staff of the organisation to keep the cash records always up-to-date.

8.3 PREPARATION OF BANK RECONCILIATION STATEMENT

A Bank Reconciliation Statement is prepared usually at the end of a period, *i.e.*, a quarter, a half year or a year, as may be found 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.

NOTES

(*i*) 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 be prepared.

(*ii*) 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.

(*iii*) 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.

(*iv*) The effect of that particular cause of difference should be studied on the balance shown by the other book.

(*v*) 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.

(*vi*) 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.

In case the book shows an adverse balance (*i.e.*, an overdraft) the amount of the overdraft should be transferred to minus column. The Recociliation Statement should then be prepared on the above basis assuming a favourable balance.

The above technique will be clear with the help of the illustrations given in the following pages.

Where Causes of Differences are Given

Illustration 8.1. From the following particulars, prepare a Bank Reconciliation Statement as on 31st December, 2017.

(*i*) Balance as per Cash Book ₹5,800.

(*ii*) Cheques issued but not presented for payment ₹2,000.

(*iii*) Cheques sent for collection but not collected up to 31st December, 2010 ₹1,500.

(*iv*) The Bank had wrongly debited the account of the firm by ₹200 which was rectified by them after 31st December.

Balance as per Pass Book is ₹6,100.

Solution:

There is a difference of ₹300 between the balance as shown by the cash book and the balance as shown by the bank pass book. A reconciliation statement can be prepared to reconcile on the following basis the balances shown by the two books:

(*i*) The balance as shown by the cash book will be taken as the starting point.

(*ii*) The cheques issued but not presented for payment have not been recorded in the bank pass book. The balance as per pass book has to be found out. The Bank has not yet passed the entry for the payment of these cheques since they have not been presented for payment. The balance, therefore, in the pass book should be more. The amount of ₹2,000 should, therefore, be added to the balance as shown by the cash book.

(*iii*) Cheques sent for collection but not yet collected must have been entered in the cash book but must not have been credited by the Bank to the firm's account since they have not yet been collected. The balance in pass book should, therefore, be less as compared to the cash book. The amount of ₹1,500 should, therefore, be deducted out of the balance as shown by the cash book.

(*iv*) The Bank has wrongly debited the firm's account. This must have resulted in reducing balance as per the bank pass book. The amount should, therefore, be deducted out of the balance shown as per the cash book.

The Bank Reconciliation Statement will now appear as follows:

BANK RECONCILIATION STATEMENT

	Particulars	(+) ₹	(–) ₹
(*i*)	Balance as per cash book	5,800	
(*ii*)	*Add:* Cheques issued but not presented for payment	2,000	
(*iii*)	*Less*: Cheques sent for collection but not yet collected		1,500
(*iv*)	*Less:* Amount wrongly debited by the Bank		200
		7,800	1,700
	Balance as per Bank Pass Book	6,100	

Illustration 8.2. From the following particulars, prepare a Bank Reconciliation Statement showing the balance as per cash book as on 31st December, 2017.

(*i*) Out of cheques of ₹9,000 paid on 29th December, ₹4,000 appear to have been credited in the pass book on 2nd January, 2010.

(*ii*) I had issued cheques in December, 2017 amounting in all to ₹16,000 out of which I find that cheques for ₹7,000 have been cashed in the same month; a cheque of ₹5,000 cashed on January 3, 2018 and the rest have not been presented at all.

(*iii*) My bankers have given me a wrong credit in my Joint Account with my wife, in respect of a cheque of ₹2,000 paid into my personal account.

(*iv*) ₹1,000 for interest on overdraft charged in the pass book on 31st December has been entered in my cash book on 4th January, 2018.

(*v*) My pass book shows a credit of ₹1,200 to my account being interest on my securities collected by my bankers.

(*vi*) The Bank balance as per my pass book showed an overdraft of ₹19,000.

NOTES

Solution:

BANK RECONCILIATION STATEMENT

(as on 31st December, 2017)

	Particulars	(+) ₹	(–) ₹
	Overdraft as per Pass Book		19,000
Add:	Cheques not yet credited	4,000	
Less:	Cheques not yet presented		9,000
Add:	Cheques not yet credited to my personal account	2,000	
Add:	Interest on overdraft charged in the Pass Book on 31st December, not entered in Cash Book	1,000	
Less:	Interest on securities collected by bankers not entered in Cash Book		1,200
		7,000	29,200
	Overdraft as per Cash Book		22,200

Illustration 8.3. Janardan & Company have bank accounts with two banks, *viz*., Dena Bank and Bank of India. On 31st December, 2017, his cash book (bank columns) shows a balance of ₹5,000 with Dena Bank and an overdraft of ₹2,250 with Bank of India. On further verification, the following facts were discovered.

(*a*) A deposit of ₹1,500 made in Dena Bank on 20th December, 2017 has been entered in the column for Bank of India.

(*b*) A withdrawal of ₹500 from Bank of India on 2nd November, 2017 has been entered in the column for Dena Bank.

(*c*) Two cheques of ₹500 and ₹750 deposited in Dena Bank on 1st December, 2017 (and entered in the Bank of India column) have been dishonoured by the Bankers. The entries for dishonour have been made in the Bank of India column.

(*d*) Cheques were issued on 29th December, 2017 on Dena Bank and Bank of India for ₹10,000 and ₹1,000 respectively. These have not been cashed till 31st December, 2017.

(*e*) Incidental charges of ₹10 and ₹25 charged by Dena Bank and Bank of India respectively have not been entered in the books.

(*f*) Dena Bank has credited an interest of ₹50 and Bank of India has charged interest of ₹275. These have not been recorded in the books.

(*g*) The deposits of ₹5,000 and ₹3,500 made into Dena Bank and Bank of India respectively have not yet been credited to by them till 31st December, 2017.

Draw up the two Bank Reconciliation Statements.

NOTES

Solution:

M/s Janardan & Company

RECONCILIATION STATEMENT WITH BANK OF INDIA

(as on 31st December, 2017)

	Particulars	(+) ₹	(–) ₹
	Balance as per Cash Book	5,000	
Add:	(*a*) Deposit made on 20.12.2017 but wrongly debited to Bank of India	1,500	
	(*b*) Withdrawal made on 2.11.2017 wrongly entered in the above account instead of Bank of India	500	
	(*c*) These entries have no effect in either account	–	
	(*d*) Cheque issued on 29.12.2017 but not yet encashed with the Bank	10,000	
Less:	(*e*) Incidental charges not yet credited by us		10
Add:	(*f*) Interest credited by Bank but not yet debited by us in our books	50	
Less:	(*g*) Cheque deposited but the proceeds of the same not yet credited by Bank		5,000
		17,050	5,010
	Balance as per Bank Pass Book (favourable)	12,040	

RECONCILIATION STATEMENT WITH BANK OF INDIA

(as on 31st December, 2017)

		Particulars	+ ₹	– ₹
Overdraft as per Cash Book				2,250
Less:	(*a*)	Deposit made into Dena Bank on 20.12.2017 but wrongly debited to the above account		1,500
	(*b*)	Withdrawal made on 21.1.2017, but wrongly entered in Dena Bank Account		500
	(*c*)	These entries have no effect in either Account		
Add:	(*d*)	Cheque issued on 29.12.2017 but not yet encashed with the bank	1,000	
Less:	(*e*)	Incidental charges not yet credited by us		25
	(*f*)	Interest charged by Bank but not yet recorded by us in the Books		275
	(*g*)	Cheques deposited, but the proceeds of the same not yet credited by Bank		3,500
			1,000	8,050
Overdraft as per Bank Pass Book				7,050

Where Cash Book Balance Has To Be Adjusted

Illustration 8.4. The Cash Book of Mr Gadbadwala shows ₹8,364 as the balance at Bank as on 31st December, 2017 but you find that this does not agree with the balance as per the Bank Pass Book. On scrutiny, you find the following discrepancies:

NOTES

(*i*) On 15th December, 2017, the payments side of the Cash Book was undercast by ₹100.

(*ii*) A cheque for ₹131 issued on 25th December, 2017 was taken in the Cash column.

(*iii*) A deposit of ₹150 was recorded in the Cash Book as if there is no Bank Column therein.

(*iv*) On 18th December, 2009, the debit balance of ₹1,526 as on the previous day, was brought forward as credit balance.

(*v*) Of the total cheques amounting to ₹11,514 drawn in the last week of December, 2017, cheques aggregating ₹7,815 were encashed in December.

(*vi*) Dividends of ₹250 collected by the Bank and subscription of ₹100 paid by it were not recorded in the Cash Book.

(*vii*) A cheque issued for ₹350 was recorded twice in the Cash Book.

Prepare a Reconciliation Statement when:

(*a*) the books are not to be closed on 31st December.

(*b*) the books are to be closed on 31st December.

Solution:

(*a*) *If the books are not to be closed on 31st December, 2017.*

BANK RECONCILIATION STATEMENT

(as on 31st December, 2017)

	Particulars		+ ₹	– ₹
	Balance as per Cash Book		8,364	
Add:	Mistake in bringing forward ₹1,526 debit balance as credit balance as on 18.12.2017		3,052	
	Cheques issued but not presented:			
	Issued	11,514		
	Cashed	7,815	3,699	
	Dividends directly collected by bank but not yet entered in the Cash Book		250	
	Cheque recorded twice in the Cash Book		350	
	Deposit not recorded in the Bank column		150	
Less:	Wrong casting in the cash book on 15.12.2017			100
	Cheques issued but not entered in the Bank column			131
	Subscription paid by the Bank directly not yet recorded in the Cash Book			100
			15,865	331
	Balance as per Pass Book		15,534	

NOTES

(*b*) *If the books are to be closed on 31st December, 2017.*

In such a case necessary corrections for mistakes committed will have to be made in the Cash Book and correct balance as per Cash Book will have to be found out. A Bank Reconciliation Statement will then be prepared.

ASCERTAINMENT OF CORRECT BALANCE

	Particulars	₹	₹
	Balance of Cash Book as given		8,364
Add:	Mistake in bringing forward the balance on 18th December		3,052
	Dividends collected by the bank		250
	Cheque recorded twice in the Cash Book		350
	Deposit not recorded in the Bank column		150
			12,166
Less:	Wrong casting of the cash Book on 15th December	100	
	Cheques issued but not entered in the Bank column	131	
	Subscription paid by the Bank directly not yet recorded in the Cash Book	100	331
Correct Balance as per Cash Book (for Balance Sheet purposes)			11,835

BANK RECONCILIATION STATEMENT

(as on 31st December, 2017)

	Particulars	₹	₹
	Balance as per Cash Book (corrected)		11,835
Add:	Cheques issued but not yet presented		3,699
	Balance as per Pass Book		15,534

WHERE ABSTRACTS FROM CASH BOOK AND PASS BOOK ARE GIVEN

In such a case there can be two situations:

(*i*) *When the abstracts relate to the same period* In this a case the transactions which are not common in both the abstracts should be found . These constitute the causes of difference (*See Illustration 8.5*).

(*ii*) *When the pass book relates to the succeeding period* In this case those transactions which are common in both the abstracts should be compared. These constitute the causes of difference (*See Illustration 8.6*).

Illustration 8.5. The following are the Cash Book and Bank Pass Book of Niranjan for the month of April, 2017.

CASH BOOK (BANK COLUMN)

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.4.2017	To Balance b/d	12,500	1.4.2017	By Salaries A/c (Ch. No. 183)	4,000
4.4.2017	To Sales A/c	8,000	6.4.2017	By Purchases A/c (Ch.No.184)	3,200
8.4.2017	To Parimal A/c	1,500	11.4.2017	By Machinery A/c (Ch. No. 185)	6,000
13.4.2017	To Mahim A/c	3,400	15.4.2017	By Om Prakash A/c (Ch. No. 186)	1,000
18.4.2017	To Kamal A/c	4,600	19.4.2017	By Drawings A/c (Ch. No. 187)	800
21.4.2017	To Furniture A/c	1,200	23.4.2017	By Kishore A/c (Ch. No. 188)	2,000
25.4.2017	To Sales A/c	3,800	27.4.2017	By Suresh A/c (Ch. No. 189)	1,000
30.4.2017	To Firoz A/c	3,000	30.4.2017	By Printing A/c (Ch. No. 189)	500
			30.4.2017	By Balance c/d	19,500
		38,000			38,000

BANK PASS BOOK

Date	*Particulars*	*Deposits* ₹	*Withdrawals* ₹	*Balance* ₹
1.4.2017	Balance			12,500
2.4.2017	Cheque 183		4,000	8,500
6.4.2017	Cash	8,000		16,500
6.4.2017	Cheque 184		3,200	13,300
10.4.2017	Cheque	1,500		14,800
16.4.2017	Cheque	3,400		18,200
17.4.2017	Cheque 187		800	17,400
20.4.2017	Cheque	4,600		22,000
24.4.2017	Cheque	3,800		25,800
28.4.2017	Cheque 185		6,000	19,800
28.4.2017	Cheque 189		1,000	18,800
30.4.2017	Interest	100		18,900
30.4.2017	Deposit (Firoz)	3,000		21,900
30.4.2017	Charges		10	21,890

You are required to prepare a Bank Reconciliation Statement as on 30th April, 2017.

Solution:

BANK RECONCILIATION STATEMENT OF NIRANJAN

(as on 30th April, 2017)

	Particulars			+ ₹	– ₹
	Balance as per Cash Book			19,500	
Less:	Amount deposited but not credited				1,200
Add:	Cheques drawn but not presented:	Cheque No. 186	1,000		
		Cheque No. 188	2,000		
		Cheque No. 190	500	3,500	
Add:	Interest allowed by bank but not posted in Cash Book			100	
Less:	Charges debited by bank but not posted in Cash Book				10
				23,100	1,210
		Balance as per Pass Book		21,890	

Illustration 8.6. From the following entries in the Bank column of the Cash Book of Mr. Kartak and the corresponding Bank Pass Book, prepare Reconciliation Statement as on 31st March, 2017:

NOTES

CASH BOOK (BANK COLUMN ONLY)

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2017			2017		
March 1	To Balance b/d	3,400	March 7	By Drawings	1,500
March 10	To Madan & Sons	500	March 8	By Salary	2,200
March 13	To Jerbai	4,000	March 15	By Ardesar & Co.	3,000
March 18	To Cawasji & Co.	1,200	March 28	By Merwan Bros.	1,550
March 28	To Dinshwa & Co.	2,200	March 29	By Raj & Sons	800
March 29	To Dhanbura Co.	5,700	March 30	By Macmillon Radios	400
March 31	To Antony	3,425	March 31	By Chandu, H.	1,600
			March 31	By Balance c/d	9,375
		20,425			20,425

BANK PASS BOOK

(Mr. Kartak in Current Account with Central Bank)

Date	*Particulars*	₹	*Date*	*Particulars*	₹
20017			2017		
April 1	To Balance (Overdraft)	750	April 2	By Dividends	500
April 2	To Raj & Sons	800	April 2	By Dinshaw & Co.	2,200
April 4	To Macmillon Radios	400	April 2	By Hosang	200
April 8	To Salary	2,300	April 3	By Dhanbura & Co.	5,700
April 10	To Drawings	500	April 3	By Antony	3,425
April 10	To Antony (Cheque dishonoured)	3,425	April 5	By Romy	170

Solution:

BANK RECONCILIATION STATEMENT OF MR. KARTAK

(as on 31st March, 2017)

	Particulars		+ ₹	– ₹
	Balance as per Cash Book		9,375	
Less:	Cheques deposited but not credited:			
	Dinshaw & Co.	2,200		
	Dhanbura Co.	5,700		
	Antony	3,425		11,325
Add:	Cheques drawn but not presented:			
	Raj & Sons	800		
	Macmillon Radios	400	1,200	
			10,575	11,325
	Overdraft as per Pass Book			750

Check Your Progress

1. How does a bank record withdrawal of money by the customer?
2. Give an example of a variation which does not require an adjusting or correcting entry.
3. When is a bank reconciliation statement prepared?

8.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. On money being withdrawn by the customer, the bank debits the account of the customer since he is the receiver.
2. An example of a variation which does not require an adjusting or correcting entry is: a cheque that has been sent for collection, but not yet collected, causes a difference between the balance as shown by the bank pass book and the balance as shown by the cash book, but no adjusting entry is required in the cash book for such a difference because, the bank will credit the firm's account as soon as the cheque is collected.
3. A bank reconciliation statement is prepared usually at the end of a period, i.e., a quarter, a half year or a year, as may be found convenient and necessary by the firm, taking into account the number of transactions involved.

8.5 SUMMARY

- The advantages of keeping an account with a bank are as follows: avoidance of risk, prevention of fraud and misappropriation, and reduction in accounting work.
- On deposits of money by the firm into the bank account, the firm debits the bank account while the bank credits the firm's account.
- On withdrawal of money by the firm from the bank, the firm credits the bank's account while the bank debits the firm's account.
- 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 maintains the firm's account in its books. A copy of this account is submitted to the firm from time to time. The account so submitted by the bank to the customer is known as the bank pass book or bank statement.
- The Pass Book or the Bank Statement is submitted by the bank to the customer for his information and verification.
- 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: cheques issued but not presented for payment, cheques sent for collection but not yet collected, bank charges, direct collections on behalf of customers and errors.

- A Bank Reconciliation Statement is a statement reconciling the balance as shown by the bank pass book and the balance as shown by the cash book. The objective of preparing such a statement is to know the causes of difference between the two balances and pass necessary correcting or adjusting entries in the books of the firm.
- It should be noted that every variation or difference does not require an adjusting or correcting entry.
- The importance of Bank Reconciliation Statement can be judged on the basis of the following facts: (i) It highlights the causes of difference between the bank balance as per cash book and the bank balance as per pass book, (ii) It reduces the chances of fraud by the staff handling cash and, (iii) There is a moral check on the staff of the organisation to keep the cash records always up-to-date.
- A Bank Reconciliation Statement is prepared usually at the end of a period, i.e., a quarter, a half year or a year, as may be found 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: cash book should be completed and balanced as per the bank column on the particular required date, bank should be requested to complete and send the firm bank pass book updated till the date required, balance shown by either the cash book or bank pass book must be used as base, the effect of particular cause of difference should be studied, adjustments should be made on the basis of increase or decrease in balance.

8.6 KEY WORDS

- **Bank Reconciliation Statement:** A statement reconciling the balance as shown by the Bank Pass Book and the balance as shown by the Cash Book.
- **Pass Book:** It is a copy of the firm’s account with a bank.

8.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What is a bank reconciliation statement?
2. List the advantages of keeping an account with a bank.
3. What are the rules of accounting as regards bank transactions?

4. How is the cash column used by firms to record transactions relating to the bank by the firm?
5. Explain the importance of bank reconciliation statement.

NOTES

Long Answer Questions

1. Illustrate the pro-forma of a Bank Reconciliation Statement with imaginary figures.
2. Explain the procedure for preparing a bank reconciliation statement.
3. "Balance as shown by the Bank Pass Book should tally with the balance as shown by the Cash Book of the business." Do you agree? If not, explain the reasons with suitable examples of difference between the two.

8.8 FURTHER READINGS

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UNIT 9 NON-TRADING ACCOUNTS

NOTES

Structure

9.0 INTRODUCTION

In the preceding units, we have explained the preparation of final accounts in the case of profit making organizations or institutions, *i.e.*, those organizations whose objective is to earn profit through business operations. However, there are organizations or institutions whose main objective is not to earn profit, but to provide service to the society. These institutions can broadly be divided into three categories:

(*i*) Institutions which work for the general welfare of their members, e.g., clubs, staff associations, residents' associations, etc.

(*ii*) Charitable institutions, *viz*., educational institutions, hospitals, etc.

(*iii*) Professional firms, *viz*., Chartered Accountants, Advocates, Tax Consultants, Doctors, etc.

The non-profit making organizations or institutions are different from the profit making institutions in several aspects. They do not have to purchase or sell goods or receive bills of exchange, nor do they have to make credit transactions. Most of their transactions are cash transactions and, therefore, they are not required to maintain detailed books of account like profit making concerns. However, they do maintain Cash Books and a minimum number of such other books which may be required for their purposes. For example, a Register of Members and a Minute Book are maintained in the case of a club or a society, a Students Fees Register is maintained in schools and colleges, a summary record of outstanding fees may be kept by an Advocate or a Chartered Accountant.

NOTES

9.1 OBJECTIVES

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

- Identify non-profit making organizations
- Get familiar with the statements or accounts which form final accounts of a non-profit making organizations
- Understand the meaning and preparation of Receipts & Payments Account and Income & Expenditure Account
- Identify and understand the accounting treatment of items which are peculiar to a non-profit making organization

9.2 PREPARATION OF FINAL ACCOUNTS OF NON-TRADING ORGANIZATIONS

At the end of the accounting period, a non-profit making institution also prepares its final accounts which include the following:

(*i*) Receipts and Payments Account

(*ii*) Income and Expenditure Account

(*iii*) Balance Sheet

In this unit, we first explain the preparation of final accounts which are applicable to all non-profit making organizations in general. However, some specific aspects relating to educational and professional institutions will be discussed later in the unit.

9.2.1 Receipts and Payments Account

Receipts and Payments Account is merely a summary of cash transactions under proper heads which have taken place during the accounting period. It is prepared at the end of the accounting period from the cash book. The Cash Book contains a record of cash receipts and cash payments in a chronological order while the receipts and payments account is a summary of the total cash receipts and the total cash payments received and made under different heads during a particular period. For example, if a club receives subscriptions from its members on different dates of the accounting year, they will be recorded on these dates separately in the Cash Book. However, Receipts and Payments Account will contain the total subscriptions received during the accounting year. Similarly, Cash Book contains the payment of salaries made on different dates of the month on different pages. The Receipts and Payments Account will show the total salaries paid during the accounting period.

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The main features of the Receipts and Payments Account can be summarised as follows:

(*i*) It is an abbreviated copy of the cash book. The cash and bank items are usually merged in one column. Thus, contra entries between cash and bank are eliminated.

(*ii*) It is a real account.

(*iii*) All cash receipts are recorded on the debit side while all the cash payments are recorded on the credit side.

(*iv*) It records all cash receipts and payments, irrespective of the fact whether they are of capital or revenue nature or whether they relate to the current year or not. Similarly, it records all the cash payments whether they are of capital or revenue nature or whether they relate to the current year or the next year. What is necessary is the receipts and the payments should have been received or made during the period to which the Receipts and Payments Account relates.

(*v*) It starts with the balance in the beginning of the accounting year and ends with the balance at the end of the accounting year.

Illustration 9.1. From the following particulars taken from the Cash Book of a Club, prepare a Receipts and Payments Account.

Particulars	₹
Opening Balance:	
Cash in Hand	100
Cash in Bank	500
Receipts:	
Subscriptions	3,300
Donations	260
Payments:	
Investment Purchased	1,000
Rent Paid	400
Postage and Stationery	70
Sundry Expenses	30
Closing Cash Balance	20

Solution:

RECEIPTS AND PAYMENTS ACCOUNT

for the year ended ...

Receipts		₹	*Payments*		₹
To Balance b/d			By Investments		1,000
Cash in Hand	100		By Rent		400
Cash in Bank	500	600	By General Expenses		210
To Subscriptions		3,300	By Postage & Stationery		70
To Donations		260	By Sundry Expenses		30
			By Balance c/d:		
			Cash in Hand	20	
			Cash at Bank (balancing figure)	2,430	2,450
		4,160			4,160

9.2.2 Income and Expenditure Account

This may be described as an equivalent to the Profit and Loss Account. It performs the same functions and is compiled and constructed on precisely the same principles. Its essential features can be put as follows:

NOTES

(*i*) It is a nominal account.

(*ii*) It records all the losses and expenses on its debit side while all the incomes and gains are recorded on its credit side.

(*iii*) The balance of this account represents either the excess of income over the expenditure (if the total of the credit side is more than that of the debit side) or the excess of expenditure over income (if the total of the debit side of the account is more than that of its credit side).

Illustration 9.2. From the information given in Illustration 9.1, prepare an Income and Expenditure Account.

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ending on ...

Expenditure	₹	*Income*	₹
To Rent	400	By Subscriptions	3,300
To General Expenses	210	By Donations	260
To Postage and Stationery	70		
To Sundry Expenses	30		
To Excess of Income Over Expenditure	2,850		
	3,560		3,560

9.2.3 Balance Sheet

Balance Sheet in the case of a non-trading concern is prepared in the usual manner and contains particulars of all the assets and liabilities of the concern/ institution on the date on which it was prepared. The excess of assets over liabilities is termed as Capital Fund. The Capital Fund is made up of excess of income over expenditure, and other income or surplus which might have been capitalised by the institution from time to time. Sometimes, two Balance Sheets may have to be prepared — (*i*) Balance Sheet in the beginning of the accounting year to ascertain the amount of Capital Fund in the beginning of the accounting year and (*ii*) Balance Sheet at the end of the accounting year to show the financial position of the Institution as on that date.

Items Peculiar to Non-Trading Concerns

The technique of preparing the Final Accounts of a non-trading concern is similar to that used for preparing the Final Accounts of a trading concern. However, there are certain peculiar items in the case of a non-trading concern. The treatment of these items and their presentation in the Final Accounts are explained below:

NOTES

1. Subscriptions: In the case of trading concerns, subscriptions are usually given, *e.g.*, subscriptions for trade journals, subscriptions for membership to a club, etc. In the case of a non-trading concern, subscriptions are usually received. For example, a club receives subscriptions from its members and this may be a major source of income to the club. The Receipts, and Payments Account records the amount of actual subscriptions received while the Income and Expenditure Account records only the subscriptions which relate to the accounting period, whether received or not. Adjustments may, therefore, be required to find out the actual amount of income from subscriptions. The following illustrations are being given to clarify this point:

Illustration 9.3. With the following extracts from the Receipts and Payments Account and the additional information given, you are required to compute the income from subscriptions for the year ending 31st December, 2017 and show the subscription item in the Final Accounts of the Club.

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31st December, 2017

Receipts	₹	*Payments*	₹
Subscriptions	10,000		

Additional Information:

(*i*) Subscriptions outstanding as on 31.12.2016, ₹2,000.
(*ii*) Subscriptions outstanding as on 31.12.2017, ₹4,000.
(*iii*) Subscriptions received in advance as on 31.12.2016, ₹3,000.
(*iv*) Subscriptions received in advance as on 31.12.2017, ₹2,000.

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st December, 2017

Expenditure	₹	*Income*	₹	
		By Subscriptions	10,000	
		Add: Subscriptions outstanding as on 31.12.17	4,000	
		Add: Subscriptions received in advance as on 31.12.16	3,000	
			17,000	
		Less: Subscriptions outstanding as on 31.12.16	2,000	
			15,000	
		Less : Subscriptions received in advance as on 31.12.2017	2,000	13,000

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BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	*Assets*	₹
Subscriptions received in advance (as on 31.12.2017)	2,000	Outstanding Subscriptions (as on 31.12.2017)	4,000

2. Donations: A charitable institution may receive donations from time to time. The amount of donations may be taken as income or capitalised and taken to the Balance Sheet depending upon whether it is a specific donation or a general donation.

(*a*) *Specific donation* In case a donation has been received for a specific purpose, the donation is termed as a specific donation. For example, an institution may receive donation for the construction of a building or for giving prizes to the best sportsman. The amount of such donation, therefore, cannot be used for any other purpose. It should be taken to the Balance Sheet (on the liabilities side) and used only for the purpose for which it is meant, irrespective of the amount.

(*b*) *General donation* A donation not received for a specific purpose is termed as a General Donation. Its treatment depends upon the amount received. In case the donation is of a substantial amount, it can be fairly taken for granted that such donation is of a non-recurring nature and therefore, should be taken to the Balance Sheet on the liabilities side. However, if the donation is of a small amount and not meant for a specific purpose, it can be safety taken to the Income and Expenditure Account.

The size and nature of the institution will decide to a great extent, the amount of donation being small or big. For example, in the case of a hospital of a moderate size, a sum of ₹10,000 can be taken as a small donation, but for a badminton club, the amount of ₹10,000 is quite substantial and therefore, it will be proper to take the amount of such donation received to the Balance Sheet.

Illustration 9.4. Following are the extracts from the Receipts and Payments Account of a sports club. You required to show the different items in the Income and Expenditure Account and the Balance Sheet of the club after taking into account the additional information given.

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31st December, 2017

Receipts	₹	*Payments*	₹
To Donations for Pavilion	5,000		
To Subscriptions for Governor's Party	2,000		
To Donations	100		

Additional Information:

(*i*) Amount spent on Pavilion ₹1,000.

(*ii*) Outstanding subscriptions for Governor's Party: ₹500.

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Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st December, 2017

Expenditure	₹	*Income*	₹
Subscriptions	10,000	By Donations	100

Balance Sheet

as on 31st December, 2017

Liabilities	₹	*Assets*	₹
Fund for Pavilion (donations received)	5,000	Outstanding subscriptions for	
Subscription for Governor's Party		Governor's Party	500
(including outstanding)	2,500	Pavilion (cost incurred)	1,000

Notes:

(*i*) The amount of donations received for the Pavilion is a specific donation and, therefore, has been taken to the liabilities side on the Balance Sheet.

(*ii*) The subscriptions received for the Governor's Party is also for a specific purpose, and, therefore, has been taken to the Balance Sheet. The amount of outstanding subscription has also been added to this amount and has been shown on both sides of the Balance Sheet.

(*iii*) The expenditure of ₹1,000 incurred on the construction of the Pavilion has been shown as an asset in the Balance Sheet. It is not to be subtracted from the Pavilion Fund. As a matter of fact, the Pavilion Fund was previously represented by cash, now it is partly represented by cash and partly by the cost incurred on the construction of the Pavilion so far.

3. Special funds: An institution may keep special funds for some special purposes. For example, a sports club may keep a special fund for meting sports expenses of for awarding of sports prizes. In case such special funds are maintained, any income relating to such special funds should be added to these funds to the liabilities side on the Balance Sheet. Similarly, all expenses on account of these funds should be deducted out of these funds. In case of a deficit, the amount should be deducted from the Income and Expenditure Account. In case of a surplus, it will be better on account of convention of conservatism to keep it in the Balance Sheet or merge it with the Capital Fund.

However, whatever has been stated above is not applicable to any income which an institution may receive on account of General Fund. Income on account of General Fund investments can very well be taken to the Income and Expenditure Account.

Illustration 9.5. Following is the information given in respect of certain items of a sports club. Your are required to show them in the Income and Expenditure Account and the Balance Sheet of the Club.

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	₹
Sports Fund as on 1.1.2017	10,000
Sports Fund Investments	10,000
Interest on Sports Fund Investments	1,000
Donation for Sports Fund	4,000
Sports Prizes awarded	3,000
Expenses on Sports Events	1,000
General Fund	20,000
General Fund Investments	20,000
Interest on General Fund Investments	2,000

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st December, 2017

Expenditure	₹	*Income*	₹
		By Interest on General Fund Investments	2,000

BALANCE SHEET

as on 31st December, 2017

Expenditure		₹	*Income*	₹
Sports Fund	10,000		Sports Fund Investments	10,000
Add: Interest on Sports Fund			General fund Investments	20,000
Investment	1,000			
Sports Fund Donations	4,000			
	15,000			
Less: Sports Prizes awarded	3,000			
	12,000			
Less: Expenses on Sports Events	1,000	11,000		
General Fund		20,000		

4. **Legacy:** Legacy refers to the amount which one gets on account of a will. The amount received on account of a legacy is as good as donation and should generally be taken to the Balance Sheet (on the liabilities side) since it is generally of a non-recurring nature. However, small amounts received on account of legacy may be taken to the Income and Expenditure Account.

5. **Entrance fee:** Entrance Fee or Admission Fee is usually charged by a club or a society or an educational institution to the new entrants. It is usually taken as an item of income. However, in the case of clubs and similar institutions some people favour capitalising the entrance fee on the ground that it is of a non-recurring nature. It is considered as being charged by the club as a premium from the new members towards the capital cost involved in establishing and maintaining the club by older members. This argument, of course, is not applicable in the case of educational institutions or hospitals

where the admission fee is charged from students or patients. [In the absence of any specific instructions in the question, the students are advised to take it as an item of income.]

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6. **Fee for life membership:** Certain institutions charge fees for making persons as life members. Such members have to pay the fee only once in their lifetime. Of course, they continue to enjoy the benefit of the institution throughout their life.

The amount received as life membership fee can e dealt in the accounts of the institution by any of the following methods:

(*i*) The amount received may be taken as a capital receipt and therefore be taken to the Balance Sheet on the liabilities side under the head "Life Membership Fee."

(*ii*) The amount received as life membership fee may be credited to a separate account, *viz*., "Life Membership Fee Account." The normal annual subscriptions may be transferred from the Life Membership Fee Account to the Income and Expenditure Account and the balance may be carried forward till it is exhausted. In the case of death of a member, the balance if any, in the Life Membership Fee Account may be transferred to the Capital Fund Account.

(*iii*) The amount received may be credited to the Life Membership Fee Account. The amount computed according to the average life of a member amy annually be transferred from this account to the Income and Expenditure Account.

Tutorial Note: The students are advised to adopt the first method in the absence of any specific instructions in an examination problem.

7. **Sale of old newspaper:** The amount received on account of sale of old newspapers is of a recurring nature and should, therefore, be taken as income in the Income and Expenditure Account.

8. **Miscellaneous:** Adjustments may have to be made in respect of certain items such as sports material, printing and stationery material, etc. to find out the actual materials used during a particular period for the concerned expenditure. This will be clear with the help of the following illustration.

Illustration 9.6. From the following information, compute the amount to be debited or credited to the Income and Expenditure Account in respect of the following items:

(*i*) Sports Material:	₹
Opening Stock as on 1.1.2017	2,000
Purchases of Sports Material during 2017	8,000
Stock of Sports Material as on 31.12.2017	3,000
Sale of Sports Material scrapped	50

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(*ii*) Printing and Stationery Material:

Opening Stock as on 1.1.2017	3,000
Purchase of Printing and Stationery	5,000
Stock of Printing and Stationery as on 31.12.2017	2,000

(*iii*) Tinned Provisions:

Stock as on 1.1.2017	2,000
Purchase during the year	10,000
Stock as on 31.12.2017	3,000
Sale of tinned provisions	15,000

Solution:

INCOME AND EXPENDITURE ACCOUNT

for the year ended on 31st December, 2017

Expenditure		₹	*Income*	₹
To Sports Material used:			By Sale of Sports Material	50
Opening Stock	2,000		By Sale of Tinned Provisions	15,000
Add: Purchases	8,000			
	10,000			
Less: Closing Stock	3,000	7,000		
To Printing and				
Stationery Material used:				
Opening Stock	3,000			
Add: Purchases	5,000			
	8,000			
Less: Closing Stock	2,000	6,000		
To Cost of Tinned				
Provisions sold:				
Opening Stock	2,000			
Add: Purchases	10,000			
	12,000			
Less: Closing Stock	3,000	9,000		

In the following pages, we are giving comprehensive illustrations to cover the four different types of problems which are generally asked in the examinations.

These types are:

(*i*) Preparation of the Income and Expenditure Account and the Balance Sheet from the Receipts and Payments Account and additional information.

(*ii*) Preparation of Receipts and Payments Account from the Income and Expenditure Account with additional information.

(*iii*) Preparation of Balance Sheet from the Receipts and Payments Account and Income and Expenditure Account.

(*iv*) Preparation of correct statements/accounts from wrong statements/ accounts.

Check Your Progress

1. State any two features of receipts and payment account.
2. What are the features of income and expenditure account?

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9.2.4 Preparation of Income and Expenditure Account and Balance Sheet from Receipts and Payments Account, etc.

Illustration 9.7. The Receipts and Payments Account of Navkar Football Club for the year ended 31st March, 2017, was as under.

Receipts	₹	*Payments*	₹
To Balance b/d (1.4.16)	48,000	By Purchase of Balls	80,000
To Subscriptions received	2,46,000	By Tournament Fees	10,000
To Interest	2,000	By Affiliation Fees	2,000
To Sale of Furniture	10,000	By Rent of Playground	5,000
To Donations for Club Building	60,000	By Refreshment Expenses	4,000
		By Travelling Expenses	30,000
		By Investments Purchased at face value	1,00,000
		By Salary	12,000
		By Miscellaneous Expenses	8,000
		By Balance c/d (31.3.17)	1,15,000
	3,66,000		3,66,000

Prepare the Club's Income and Expenditure Account for the year ended 31st March, 2017, and the Balance Sheet as on that date, after taking the following information into account:

(1) The subscriptions received include ₹10,000, outstanding subscriptions of the year 2015-16. Subscriptions for the year 2016-2017 amounting to ₹16,000 is still outstanding from members. Some members have paid subscriptions for the year 2017-18 amounting to ₹8,000 which is included in the subscriptions received.

(2) Interest accrued but not received: ₹500.

(3) The book value of the furniture sold was ₹14,000.

(4) The rent of playground: ₹6,000 and salary: ₹5,000 of the year 2016-17 are still outstanding and rent of playground of the year 2015-16: ₹1,000 has been paid during this year.

(5) There is a stock of balls with the club valued at ₹4,000 as on 31st March, 2017.

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Solution:

Navkar Football Club

INCOME AND EXPENDITURE ACCOUNT

for the year ended 31st March, 2017

Expenditure		₹	*Income*		₹
To Balls consumed	80,000		By Subscriptions	2,46,000	
Less: Closing stock	4,000	76,000	*Add*: Outstanding for		
To Tournament Fees		10,000	the current year	16,000	
To Affiliation Fees		2,000		2,62,000	
To Rent of Playground	5,000		*Less*: Outstanding for		
Add: Outstanding for			last year	10,000	
the current year	6,000			2,52,000	
	11,000		*Less*: Received in		
Less: Rent Outstanding			advance for next year	8,000	2,44,000
for last year	1,000	10,000	By Interest	2,000	
			Add: Interest due but		
To Refreshment of Players		4,000	not received	500	2,500
To Players' Travelling Expenses		30,000			
To Salary	12,000				
Add: Outstanding for					
the current year	5,000	17,000			
To Office Expenses		8,000			
To Loss on Sale of Furniture					
(14,000 – 10,000)		4,000			
To Excess of Income					
over Expenditure		85,500			
		2,46,500			2,46,500

Navkar Football Club

BALANCE SHEET

as on 31st March, 2017

Liabilities		₹	*Assets*	₹
Subscriptions received in advance		8,000	Cash	1,15,000
Outstanding Expenses:			Investments	1,00,000
Salary	5,000		Accrued Interest	500
Rent	6,000	11,000	Outstanding Subscriptions	16,000
Building Fund		60,000	Stock of Balls	4,000
Capital Fund as on 1.4.16	71,000			
Add: Excess of Income over				
Expenditure	85,500	1,56,500		
		2,35,500		2,35,500

Working Note:

Navkar Football Club

BALANCE SHEET

as on 1st April, 2016

Liabilities	₹	*Assets*	₹
Outstanding Rent for 2015-16	1,000	Cash	48,000
Capital Fund	71,000	Subscriptions Outstanding	10,000
(balancing figure)		Furniture	14,000
	72,000		72,000

Illustration 9.8. The United Club closes its accounts on a calendar year basis. It runs a pantry and provides general services. On 1st January, 2017, it laid a

tennis court on the pursuation of some its members, on the understanding that half the cost incurred in laying the court would be met by the said members individually and that the maintenance of the court would be subsidised fully by them.

The following figures are furnished to you by the accountant of the Club for the year ended 31st December, 2017.

Particulars	₹
General Fund	1,25,000
Admission fees from members	10,000
Membership subscriptions	57,000
Audit fees	250
Subscriptions outstanding as on 1-1-17	3,000
Pantry stock as on 1-1-17	300
Bank balance	1,275
Cash in hand	95
Pantry sales	70,000
Tennis court maintenance collections	5,000
Rent outstanding as on 1-1-17	1,500
Pantry purchases	40,000
Salaries and Wages	30,000
Tennis court laying expenses	4,000
Marker's wages	1,800
Salaries of stewards, bearers and cooks	24,080
Sundry creditors for pantry purchases	2,630
Subscriptions to books and periodicals	17,060
Sports Equipments	19,800
Furniture & Fittings (Pantry)	24,770
Fixed Deposits with Banks	70,000
Library	8,000
Rent	21,000
Printing & Stationery	5,700

Additional Information:

(1) 2017 subscription in arrears was ₹1,400 and 2018 subscription received this year was ₹480.

(2) The monthly rent was ₹1,500.

(3) Fixed Deposits in Banks were made: ₹15,000 on 1st April, 2017; ₹30,000 on 1st September, 2016 and the balance on 1st October, 2017. Interest on these deposits for the current year has not been received and is at 8% per annum.

(4) Depreciation at the rate of 15% on Library, 10% on furniture and fittings and 30% on sports equipments was to be provided.

(5) In connection with the inauguration of the tennis court, the club on its own brought out a souvenir. Printing expenses on this came to ₹1,000 and these remained unpaid as on 31st December. Amounts due from the

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advertisers was ₹1,500. This figures have not been taken into account by the accountant.

(6) Salaries and wages of ₹30,000 include salary of ₹9,000 to the Manager of the club. Manager's salary is to be distributed between the Pantry, General and Tennis court in the ratio of 3 : 2 : 1, and the remaining amount among the departments in the ratio of 5 : 4 : 1.

(7) Bills for the supply of provisions to the Pantry in December, 2017 amounted to ₹1,750 which was neither paid nor taken into account.

(8) Pantry stock on hand as on 31st December, 2017 was valued at a cost of ₹250.

(9) Subscriptions to periodicals to the extent of ₹3,950 had been paid in advance.

You are required to prepare an Income and Expenditure Account in columnar form for the year ended 31st December, 2017, and the Balance Sheet as on that date.

Solution: (*See page* 242 and below)

Working Notes:

			₹
(*i*)	Subscription as per books		57,000
	Less: For tennis court*	2,000	
	Received in advance	480	
	Received for 2016	3,000	5,480
			51,520
	Add: Outstanding for 2017		1,400
			52,920
(*ii*)	Materials consumed:		
	Purchases as per books		40,000
	Add: Bills Outstanding		1,750
	Opening Stock		300
			42,050
	Less: Closing Stock		250
			41,800

		General	Pantry	Tennis
		₹	₹	₹
(*iii*)	Salaries of stewards, bearers, etc.		24,080	
	Marker's wages			1,800
	Others salaries	8,400	10,500	2,100
		8,400	34,580	3,900

(*iv*) It is assumed that the publication of the souvenir does not affect the amount to be collected from the members for the laying of the tennis court and its maintenance.

(*v*) In the absence of rates, depreciation was not provided on the tennis court.

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Solution:

United Club

INCOME & EXPENDITURE ACCOUNT

as on 31st December, 2017

Expenditure		*General (₹)*	*Pantry (₹)*	*Tennis (₹)*	*Total (₹)*	*Income*	*General (₹)*	*Pantry (₹)*	*Tennis (₹)*	*Total (₹)*
To Materials consumed			41,800		41,800	By Subscriptions	52,920		5,000	57,920
To Salaries & Wages:						By Sales		70,000		70,000
General		8,400	34,580	3,900	46,880					
Manager		3,000	4,500	1,500	9,000					
						By Advertisement	1,500			1,500
To Printing & Stationery		5,700				By Interest on Deposits	3,800			3,800
Add: Outstanding		1,000			6,700	By Deficit (Excess of Expenditure		13,357		11,737 *
To Rent		18,000			18,000	over Income)				
To Subscription &						By Deficit recoverable			400	400
Periodicals	17,060					from Tennis players				
Less: Prepaid	3,950	13,110			13,110					
To Audit fee		250			250					
To Depreciation:										
Library @ 15%		1,200			1,200					
Fittings & Fixtures @ 10%		2,477	2,477							
Sports Equipment @ 30%		5,940			5,940					
To Excess of Income										
over Expenditure		1,620			—					
		58,220	83,357	5,400	1,45,357		58,220	83,357	5,400	1,45,357

* ₹13,357 – ₹1,620 = ₹11,737

United Club

BALANCE SHEET

as on 31st December, 2017

Liabilities		₹	*Assets*		₹
General Fund:			Furniture & Fittings		24,770
Opening Balance	1,25,000		*Less*: Depreciation		2,477
Add: Admission Fee	10,000				22,293
	1,35,000		Sports Equipment	19,800	
Less: Excess of Expenditure			*Less*: Depreciation	5,940	13,860
over Income	11,737	1,23,263	Library	8,000	
			Less: Depreciation	1,200	6,800
Sundry Debtors:					
For Purchases	4,380		Tennis courts (Cost excluding amount		
Expenses	1,000	5,380	contributed by members**)		2,000

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Liabilities	₹	Assets		₹
Subscription received in advance	480			
		Sundry Debtors:		
		Subscriptions outstanding	1,400	
		Advertisers	1,500	
		Tennis players	400	3,300
		Subscriptions to periodicals, paid in advance		3,950
		Rent paid in advance		1,500
		Pantry Stock		250
		Fixed Deposits with Banks		70,000
		Interest accrued on Deposits		3,800
		Cash in Bank		1,275
		Cash in Hand		95
	1,29,123			1,29,123

9.2.5 Preparation of Receipts and Payments Account from Income and Expenditure Account and the Balance Sheet

This requires finding out the Cash receipts and Cash payments received or made during the accounting year. It can be done by simply putting the things in reverse gear, *i.e.*, items which were added while preparing an Income and Expenditure Account from a Receipts and Payments Account should now be subtracted and vice versa.

Illustration 9.9. The Income and Expenditure accounts of the Delhi Club for the year 2017 is as follows:

INCOME AND EXPENDITURE ACCOUNT

for the year ended 31.12.2017

Expenditure	₹	Income	₹
To Salaries	4,750	By Subscriptions	7,500
To General Expenses	500	By Entrance Fees	250
To Audit Fees	250	By Contribution for Annual Dinner	1,000
To Secretary's Honorarium	1,000	By Profit on Annual Sports	750
To Printing and Stationery	450		
To Annual Dinner Expenses	1,500		
To Insurance and Bank Charges	150		
To Depreciation	300		
To Surplus	600		
	9,500		9,500

This account has been prepared after the following adjustments:	₹
Subscriptions outstanding at the end of 2016	600
Subscriptions received in advance on 31.12.2016	450
Subscriptions received in advance on 31.12.2017	210
Subscriptions outstanding as on 31.12.2017	750

The salaries outstanding at the beginning and end of 2017 were ₹400 and ₹450 respectively. General expenses include insurance prepaid to the extent of ₹60. Audit fees for 2017 are unpaid as yet. During 2017 audit fees for the year 2016 were paid amounting to ₹200.

NOTES

The club owned a freehold lease of grounds valued at ₹10,000. The club had sports equipments valued at ₹2,600 as on 1.1.2017. At the end of the year, after depreciation, the equipment amounted to ₹2,700. In 2016, the club had raised a bank loan of ₹2,000. This was outstanding throughout 2017. On 31st December, 2017 cash in hand amounted to ₹1,600.

Prepare a Receipts and Payments Account for the year 2017 and a Balance Sheet at the end of the year.

Solution:

Delhi Club

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31.12.2017

Particulars		₹	*Particulars*		₹
To Balance b/d (balancing figure)		1,390	By Salaries	4,750	
			Less: Outstanding at the		
To Subscriptions	7,500		end of 2016	450	
Add: Outstanding 2016	600			4,300	
	8,100		*Add*: Outstanding in the		
Less: Received in			beginning of 2016	400	4,700
advance 2016	450		By General Expenses	500	
	7,650		*Add*: Prepaid	60	560
Add: Received in			By Audit Fee for 2016		200
advance 2017	270		By Secretary's Honorarium		1,000
	7,920		By Printing & Stationery		450
Less : Outstanding 2017	750	7,170	By Annual Dinner Expenses		1,500
To Entrance Fee		250	By Insurance and Bank Charges		150
To Contribution to Annual Dinner		1,000	By Sports Equipment purchased		400
To Profit on Annual Sports		750	By Balance: Cash in hand		1,600
		10,560			10,560

Sports Equipment

Particulars	₹	*Particulars*	₹
To Balance b/d	2,600	By Depreciation	300
To Cash (Purchases)	400	By Balance c/d	2,700
	3,000		3,000

Delhi Club

BALANCE SHEET

as on 31st December, 2017

Particulars		₹	*Assets*	₹
Subscription received in advance		270	Cash in Hand	1,600
Salaries Outstanding		450	Subscriptions Outstanding	750
Audit Fee Outstanding		250	Sports Equipments	2,700
Bank Loan		2,000	Freehold Grounds	10,000
Capital Fund:			Prepaid insurance	60
as on 1.1.2017	11,540			
Add: Surplus	600	12,140		
		15,110		15,110

NOTES

Working Notes:

Delhi Club

BALANCE SHEET

as on 31st December, 2016

Liabilities	₹	*Assets*	₹
Subscription Received in Advance	450	Cash in Hand	1,390
Salaries Outstanding	400	Subscriptions Outstanding	600
Audit Fee Outstanding	200	Sports Equipments	2,600
Bank Loan	2,000	Freehold Grounds	10,000
Capital Fund	11,540		
	14,590		14,590

Illustration 9.10. Chail Cricket Club gives you the following information:

INCOME AND EXPENDITURE ACCOUNT

for the year ended 31.12.2017

Expenditure	₹	*Income*		₹
To Remuneration to Coach	18,000	By Donations & Subscriptions		1 ,02,000
To Salaries & Wages	24,000	By Bar Room:		
To Rent	12,000	Receipts	24,000	
To Repairs	11,000	Expenses	20,000	4,000
To Miscellaneous Expenses	7,000	By Bank Interest		2,000
To Honorarium to Secretary	18,000	By Hire-Club Hall		12,000
To Depreciation on Equipment	5,000			
To Surplus	25,000			
	1,20,000			1 ,20,000

BALANCE SHEET

as on 31.12.2016 and 2017

Liabilities	2016 ₹	2017 ₹	*Assets*	2016 ₹	2017 ₹
Capital Fund as on			Equipment	25,000	20,000
31st December	48,000	48,000	Outstanding		
Entrance Fees	—	10,000	Subscriptions	6,000	8,000
Surplus	—	25,000	Cash in Hand	5,000	4,000
	48,000	83,000	Cash in Bank	2,500	10,000
Subscriptions in Advance	4,000	3,000	Fixed Deposit	20,000	50,000
Outstanding Liabilities:					
Miscellaneous Expenses	1,500	1,000			
Salary & Wages	2,000	3,000			
Honorarium to Secretary	3,000	2,000			
	58,500	92,000		58,500	92,000

Prepare the Receipts and Payments Account of the Club for the year ended 31st December 2017.

Solution:

Chail Cricket Club

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31 December, 2017

NOTES

Receipts	₹	*Payments*	₹
To Balance b/d:		By Remuneration to Coach	18,000
Cash in hand	5,000	By Rent	12,000
Cash in Bank	2,500	By Repairs	11,000
To Donations & Subscriptions	99,000	By Misc. Expenses	7,500
To Entrance Fee	10,000	By Salaries & Wages	23,000
To Bar Receipts	24,000	By Honorarium to Secretary	19,000
To Bank Interest	2,000	By Fixed Deposit	30,000
To Hire charges of Club Hall	12,000	By Bar Expenses	20,000
		By Balance c/d:	
		Cash in Hand	4,000
		Cash at Bank	10,000
	1,54,500		1,54,500

Working Notes:

		₹	₹
(*i*)	Donations & Subscriptions received:		
	As per Income & Expenditure A/c		1,02,000
	Add: Received for 2017		3,000
	Received for 2016		6,000
			1,11,000
	Less: Outstanding for 2017	8,000	
	Received in 2016 for 2017	4,000	12,000
			99,000
(*ii*)	Salaries and Wages paid:		
	Salaries & Wages as per income & Expenditure A/c		24,000
	Add: Paid for 2016		2,000
			26,000
	Less: Outstanding for 2017		3,000
			23,000
(*iii*)	Honorarium paid to Secretary:		
	As per Income & Expenditure A/c		18,000
	Less: Outstanding for 2017		2,000
			16,000
	Add: Paid for 2016		3,000
			19,000
(*iv*)	Misc. Expenses paid:		
	As per Income & Expenditure Account		7,000
	Less: Outstanding for 2017		1,000
			6,000
	Add: Paid for 2016		1,500
			7,500

NOTES

9.2.6 Preparation of Balance Sheet from Receipts and Payments Account and Income and Expenditure Account

This requires the following steps:

1. Ascertain the amount of Capital Fund in the beginning of the accounting year by preparing an Opening Balance Sheet.
2. Compare each item of the Income and Expenditure Account with each item of the Receipts and Payments Account. This will help in ascertaining the amount of outstanding or prepaid expenses or incomes. For example, if the Income and Expenditure Account shows the amount of salary as ₹10,000 while the Receipts and Payments Account show a payment of only ₹8,000, it means that a salary of ₹2,000 is outstanding.
3. The fixed assets shown in the Opening Balance Sheet should be taken in the Closing Balance Sheet after charging depreciation as per the Income and Expenditure Account:
4. Sale or Purchase of any asset should be ascertained from the Receipts and Payments Account.
5. The amount of cash in hand as well as cash in bank, at the end of the accounting year, should be ascertained from the Receipts and Payments Account.

Illustration 9.11: The following particulars relate to the Ajmer Club:

Income and Expenditure Account

for the year ended 31.12.2017

Expenditure	₹	*Income*	₹
To Salaries	1,500	By Entrance Fees	10,500
To Printing & Stationery	2,200	By Subscriptions	15,600
To Advertising	1,600	By Rents	4,000
To Audit Fees	500		
To Fire Insurance	1,000		
To Depreciation on Sports Equipments	9,000		
To Excess of Income over Expenditures	14,300		
	30,100		30,100

Receipts and Payments Account

for the year ended 31.12.2017

Receipts	₹	*Payments*	₹
To Balance b/d	4,200	By Salaries	1,000
To Entrance Fees	10,500	By Printing & Stationery	2,600
To Subscriptions:		By Advertising	1,600
2016	600	By Fire Insurance	1,200
2017	15,000	By Investments	20,000
2018	400	By Balance c/d	7,800
To Rents Received	3,500		
	34,200		34,200

The Assets on 1.1.2017 included Club Grounds and Pavilion ₹44,000; Sports Equipments ₹25,000 and Furniture and Fixtures ₹4,000. Subscriptions in arrears as on that date were ₹800.

Prepare the Balance Sheet as on 31.12.2017.

Solution:

Balance Sheet

as on 31st December 2017

Liabilities		₹	*Assets*	₹
Subscriptions received in advance		400	Club Grounds and Pavilion	44,000
Salaries Outstanding		500	Sports Equipments	16,000
Audit Fees Outstanding		500	Furniture & Fixtures	4,000
Capital Fund	78,000		Subscriptions Outstanding	800
Add: Excess of Income			Cash in Hand	7,800
over Expenditure	14,300	92,300	Rent Receivable	
			Outstanding	500
			Fire Insurance Prepaid	200
			Printing & Stationery	
			Prepaid	400
			Investments	20,000
		93,700		93,700

NOTES

Working Note:

BALANCE SHEET

as on 1st January, 2017

Liabilities	₹	*Assets*	₹
Capital Fund (balancing figure)	78,000	Club Grounds and Pavilion	44,000
		Sports Equipments	25,000
		Furniture & Fixtures	4,000
		Subscriptions Outstanding	800
		Cash in Hand	4,200
	78,000		78,000

Note: ₹400 for Printing and Stationery was assumed to have been paid in advance. ₹200 was assumed in respect of Insurance for the next year.

9.2.7 Preparation of Correct Accounts from the Wrong Accounts Given

Illustration 9.12. The account given below has been submitted to you for audit. If you do not approve of it, criticise and amend it. Also prepare the Balance Sheet of the Club.

Able Checkers Society

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st Dec., 2017

Expenditure		₹	*Income*	₹
To Entrance Fees (21 @ 10)		210	By Salaries & Wages	675
To Fees for Life Membership			By Secretary's Salary	350
(5 @ ₹52)		260	By Rent, Rates etc.	1,265
To Annual subscription	1,565		By Printing & Postage	37
Annual subscription			By Repairs to Premises	124
paid in advance	65	1,630	By Interest on Bank Loan	57
To Interest on G.P. Notes		70	By Balance carried down	960
To Sundry Receipts		60		
To Balance from last year		1,238		
		3,468		3,468

Treasurer's Note: The subscriptions in arrears amount to ₹120. Sundry Tradesmen's bills of ₹42 were outstanding as on 31st December, but have since been paid. The Secretary's salary although sanctioned by the resolution of the Committee has not yet been paid. The 3½% G.P. Notes of the face value ₹2,000 were purchased at ₹90. The lease of the club premises cost ₹2,124. The balance of the Bank Loan now outstanding is ₹1,000 secured by mortgage on the leasehold premises.

NOTES

Solution:

Able Checkers Society

INCOME AND EXPENDITURE ACCOUNT

for the year ending 31st December, 2017

Expenditure	₹	*Income*		₹
To Salaries & Wages	675	By Entrance Fees		210
To Secretary's Salary outstanding	350	By Annual Subscription	1,630	
To Rent, Rates etc.	1,265	*Less:* Received in advance	65	1,565
To Printing and Postage	37	By Interest on G.P. Notes		70
To Repairs to Premises	124	By Sundry Receipts		60
To Interest on Bank Loan	57	By Excess of Expenditure over		
To Sundry Expenses outstanding	42	Income		645
	2,550			2,550

Able Checkers Society

BALANCE SHEET

as on 31.12.2017

Particulars		₹	*Particulars*	₹
Subscriptions recd. in advance		65	Cash in hand	1,190
Outstanding Secretary's salary		350	G.P. Notes	1,800
Outstanding Sundry Expenses		42	Outstanding Subscriptions	120
Bank Loan		1,000	Leasehold Club Premises	2,124
Fee for Life Membership		260		
Capital Fund	4,162			
Less: Excess of Expenditure				
over Income	645	3,517		
		5,234		5,234

Working Notes:

RECEIPTS & PAYMENTS ACCOUNT

Receipts	₹	*Payments*	₹
To Balance b/d	1,238	By Salaries & Wages	675
To Entrance Fees	210	By Rent, Rates etc.	1,265
To Fees for Life Membership	260	By Printing & Postage	37
To Subscriptions received (1,565 – 120 + 65)	1,510	By Repairs to Premises	124
To Interest on G.P. Notes	70	By Interest on Bank Loan	57
To Sundry Receipts	60	By Balance c/d	1,190
	3,348		3,348

Balance Sheet

as on 1st January, 2017

Particulars	₹	*Particulars*	₹
Bank Loan	1,000	Cash in hand	1,238
Capital Fund	4,162	G.P. Notes	1,800
		Leasehold Club Premises	2,124
	5,162		5,162

NOTES

Illustration 9.13. The chief accountant of "Best Club Limited" suddenly expired on December 31, 2017, and the following information were available on that date:

(*a*) The Books of Account were maintained improperly and the last Balance Sheet as on December 31, 2016 showed the following:

Assets:	₹	₹
Furniture and Fixtures	76,570	
Less: Depreciation to date	36,570	40,000
Bar Stocks	26,560	
Members' Subscription	720	
Bank Balance	96,820	
Cash in hand	1,900	1,26,000
Total		1,66,000
Liabilities:		
General Fund		1,52,540
Creditors for Bar Purchases		13,100
Members' Subscription in advance		360
Total		1,66,000

(*b*) Members of the club paid an annual subscription of ₹60. Duplicate receipts issued showed that as on December 31, 2017, 540 members had paid the current year's subscription, 10 members paid arrears of previous year and 5 members paid advance for 2018. Two members resigned without paying their arrears of previous year and as at the end of the year, there were 550 members as per the records.

(*c*) The Cash Book was not written up-to-date and the records showed that the following bills were paid:

	₹
Food for Bar	33,280
Sundry Expenses	5,440
Repairs and Renewals	2,400
Salaries	36,690
Stationery	2,290

(*d*) The Club's main source of Income was from bar sales and the bartender generally hands over daily cash collections to the accountant along with cash collection list. On enquiry, it was found that certain cash collection lists were misplaced or lost. The bartender stated that the average gross profit on bar sales were fifty per cent of sales. Bar stocks as on December 31, 2017 were ₹30,260 and cash on hand ₹125.

(*e*) Summarised Bank Statements showed the following:

Particulars	₹	*Particulars*	₹
Balance as on 1.1.2017	96,820	Bar Purchases	2,39,040
Cash Deposited	3,92,310	Salaries	1,19,450
		Rent	62,420
		Power	12,570
		Telephone	910
		Repairs and Renewals	18,510
		Washing Machine	5,940
		Balance on 31.12.2017	30,290
Total	4,89,130	Total	4,89,130

(*f*) The accountant's records were searched and following unpaid bills were located:

NOTES

	₹
Bar Purchases	62,540
Power	1,830
Stationery	2,170
Telephone	460

From the above inadequate date, you are required to prepare (1) an Income and Expenditure Account for the year ended December 31, 2017 and (2) a Balance Sheet as on that date after providing depreciation at 20 per cent on written down value of Fixed Assets.

Solution:

Best Club Ltd.

INCOME & EXPENDITURE ACCOUNT

as on 31st December, 2017

Expenditure	₹	*Income*		₹
To Bar Stock Consumed	2,84,780	By Subscriptions		33,000
To Bar Food	33,280	By Bar Sales	5,69,560	
To Sundry Expenses	5,440	*Less*: Pilferage	1,32,225	4,37,335
To Repairs & Renewals (₹2,400 + 18,510)	20,910	By Excess of Expenditure over		
To Salaries (₹1,19,450 + 36,690)	1,56,140	Income transferred to		
To Stationery (₹2,290 + 2,170)	4,460	General Fund		1,22,173
To Rent	62,420			
To Power (₹12,570 + 1,830)	14,400			
To Bad Debts	120			
To Telephone (₹910 + 460)	1,370			
To Depreciation*	9,188			
	5,92,508			5,92,508

Balance Sheet

as on 31st December, 2017

Liabilities		₹	*Assets*		₹
General Fund			Fixed Assets as on 1.1.17	76,570	
Balance as on 1.1.17	1,52,540		Additions		
Less: Excess of Exp. over			(Washing Machine at Cost)	5,940	
Income for the year	1,22,173	30,367		82,510	
			Less: Depreciation	45,758	36,752
Members Subscription in Advance			Bar Stocks		30,260
(See Subscription A/c)		300	Members Subscription Due		
Sundry Creditors		67,000	(see Subscription A/c)		240
			Bank Balance		30,290
			Cash in Hand		125
		97,667			97,667

Working Notes:

(1) Sundry Creditors

	₹
(*i*) Bar Purchases	62,540
(*ii*) Power	1,830
(*iii*) Stationery	2,170
(*iv*) Telephone	460
	67,000

*Depreciation 20% of (Furniture and Fixture ₹40,000 + Washing Machine ₹5,940) ₹45,940 = ₹9,188

(2) Creditors for Bar Purchases

Particulars	₹	Particulars	₹
To Bank	2,39,040	By Balance b/d	13,100
To Balance c/d	62,540	By Purchases (Balancing figure)	2,88,480
	3,01,580		3,01,580

NOTES

(3) BAR STOCKS

Particulars	₹	Particulars	₹
To Opening Balance	26,560	By Stocks Sold (Balancing figure)	2,84,780
To Purchases	2,88,480	By Closing Stock	30,260
	3,15,040		3,15,040

(4) BAR SALES

Particulars	₹
Cost of Goods sold	2,84,780
Profit (50% of sales)	2,84,780
	5,69,560

(5) RECEIPTS AND PAYMENTS ACCOUNT

Receipts		₹	Payments	₹
To Balance 1.1.17		1,900	By Bar Food	33,280
To Bar Sales	5,69,560		By Sundry Expenses	5,440
Less: Pilferage	1,32,225	4,37,335	By Repairs and Renewals	2,400
(Balancing figure)			By Salaries	36,690
To Members Subscription		33,300	By Stationery	2,290
			By Bank Deposits	3,92,310
			By Balance (31.12.17)	123
		4,72,535		4,72,535

(6) MEMBERS' SUBSCRIPTION ACCOUNT

Particulars	No. of Members	₹	Particulars	No. of Members	₹
To Balance b/d	12	720	By Balance b/d	6	360
To Income & Expenditure A/c	550	33,000	By Receipts:		
To Balance c/d	5	300	Current	540	32,400
			Arrears	10	600
			Advance	5	300
			By Bad Debts	2	120
			By Balance c/d	4	240
	567	34,020		567	34,020

Check Your Progress

3. How are the receipts and payments accounts prepared from income and expenditure account and balance sheet?
4. How is the preparation of balance sheet done from receipts and payments account and income and expenditure account?

9.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. The main features of the Receipts and Payments Account can be summarised as follows:
   (i) It is an abbreviated copy of the cash book. The cash and bank items are usually merged in one column. Thus, contra entries between cash and bank are eliminated.
   (ii) It is a real account.
2. The essential features of income and expenditure account can be put as follows:
   (i) It is a nominal account.
   (ii) It records all the losses and expenses on its debit side while all the incomes and gains are recorded on its credit side.
   (iii) The balance of this account represents either the excess of income over the expenditure (if the total of the credit side is more than that of the debit side) or the excess of expenditure over income (if the total of the debit side of the account is more than that of its credit side).
3. The preparation of receipts and payment account requires finding out the Cash receipts and Cash payments received or made during the accounting year. It can be done by simply putting the things in reverse gear, i.e., items which were added while preparing an Income and Expenditure Account from a Receipts and Payments Account should now be subtracted and vice versa.
4. This requires the following steps:
   - Ascertain the amount of Capital Fund in the beginning of the accounting year by preparing an Opening Balance Sheet.
   - Compare each item of the Income and Expenditure Account with each item of the Receipts and Payments Account. This will help in ascertaining the amount of outstanding or prepaid expenses or incomes.
   - The fixed assets shown in the Opening Balance Sheet should be taken in the Closing Balance Sheet after charging depreciation as per the Income and Expenditure Account.
   - Sale or Purchase of any asset should be ascertained from the Receipts and Payments Account.
   - The amount of cash in hand as well as cash in bank, at the end of the accounting year, should be ascertained from the Receipts and Payments Account.

9.4 SUMMARY

- Receipts and Payments Account is merely a summary of cash transactions under proper heads which have taken place during the accounting period. It is prepared at the end of the accounting period from the cash book.
- The Cash Book contains a record of cash receipts and cash payments in a chronological order while the receipts and payments account is a summary of the total cash receipts and the total cash payments received and made under different heads during a particular period.
- Balance Sheet in the case of a non-trading concern is prepared in the usual manner and contains particulars of all the assets and liabilities of the concern/institution on the date on which it was prepared.
- The technique of preparing the Final Accounts of a non-trading concern is similar to that used for preparing the Final Accounts of a trading concern. However, there are certain peculiar items in the case of a non-trading concern.
- Legacy refers to the amount which one gets on account of a will. The amount received on account of a legacy is as good as donation and should generally be taken to the Balance Sheet (on the liabilities side) since it is generally of a non-recurring nature. However, small amounts received on account of legacy may be taken to the Income and Expenditure Account.
- The fixed assets shown in the Opening Balance Sheet should be taken in the Closing Balance Sheet after charging depreciation as per the Income and Expenditure Account:
- Sale or Purchase of any asset should be ascertained from the Receipts and Payments Account.
- The amount of cash in hand as well as cash in bank, at the end of the accounting year, should be ascertained from the Receipts and Payments Account.

9.5 KEY WORDS

- **Income and expenditure account:** A final statement often prepared by non-profit making institutions to present their revenues and expenses for an accounting period, and shows the excess of revenues over expenses (or vice-versa) for that period.
- **Receipts and expenditure account:** An account often prepared by professionals, presenting their revenues on cash basis and expenses on mercantile basis for an accounting period to show the excess of receipts over expenditure (or vice-versa) for that period.

- **Receipts and payments account:** A summary of cash transactions, often prepared by non-profit making organizations, presenting receipts and payments for an accounting period and showing the excess of receipts over payments (or vice-versa) for that period.

NOTES

9.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State whether each of the following statement is 'True or False'.
   (i) Receipts and Payments Account is a nominal account.
   (ii) Income, and Expenditure Account is a real account.
   (iii) Receipts and Payments Account starts with an opening balance.
   (iv) Income and Expenditure Account records all the incomes and expenses received or paid during the year in cash.
2. Select the most appropriate answer.
   (i) Donations received for a special purpose will be taken to the
      (a) Income and Expenditure Account
      (b) Assets side of the Balance Sheet
      (c) Liabilities side of the Balance Sheet.
   (ii) Receipts and Payments Account record receipts and payments of
      (a) Capital nature only
      (b) Revenue nature only
      (c) Both capital and revenue nature.
   (iii) Income and Expenditure Account is
      (a) a real account.
      (b) a normal account.
      (c) a personal account.

Long Answer Questions

1. State the difference between Receipts and Payments Account and Income and Expenditure Account.
2. Explain the meaning of the following terms and show how you will deal with them while preparing the Final Accounts of a club. Your answer should be supported by proper examples:
   (a) Subscriptions (b) Entrance Fee
   (b) Life Membership Fee (d) Donations

(e) Receipts for a Sports Fund (f) Loss on sale of an old fixed asset

(g) Legacy.

3. Distinguish between 'Profit and Loss account' and 'Income and Expenditure account'.

NOTES

9.7 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

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UNIT 10 DEPRECIATION ACCOUNTING

NOTES

Structure

10.0 INTRODUCTION

The concept of depreciation is closely linked to the concept of business income. In the revenue generating process the use of long-term assets tend to consume their economic potential. At some point of time these assets become useless and are disposed of and possibly replaced. The economic potential so consumed represents the expired cost of these assets and must be recovered from the revenue of the business in order to determine the income earned by the business. Depreciation may, therefore, be defined as that portion of the cost of the assets that is deducted from revenue for assets services used in the operation of a business. Depreciation is thus allocating the cost of assets to the business over the useful life of the asset. It is thus a process of allocation and not of valuing the assets. This unit will introduce you to the method of depreciation accounting.

10.1 OBJECTIVES

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

- Discuss the meaning of depreciation in accounting
- Describe the need and cause of depreciation
- Explain the methods for providing depreciation

10.2 DEPRECIATION ACCOUNTING: FUNDAMENTAL CONCEPTS

In this section, we will study the meaning, need, features and causes of depreciation.

In order to have a clear understanding about the concept of depreciation, it will be useful to quote definitions given by some prominent writers.

According to Pickles, "Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset".

The Institute of Chartered Accountants of England and Wales defines depreciation as "that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned".

According to Spicer and Pegler, depreciation may be defined as, "the measure of the exhaustion of the effective life of an asset from any cause during a given period".

From the above definitions, it can be concluded that depreciation is a gradual decrease in the value of an asset from any cause. In this unit, we will learn the concept of depreciation accounting. We will study the meaning, causes, need and computation of depreciation along with the methods of depreciation.

10.2.1 Factors Affecting Depreciation

The causes of depreciation are as follows:

1. **Wear and tear:** Assets get worn or torn out on account of constant use as is the case with plant and machinery, furniture and fixtures used in a factory.
2. **Exhaustion:** An asset may get exhausted through working. This is the case with mineral mines, oil wells etc. On account of continuous extraction of minerals or oil, a stage comes when the mine or well gets completely exhausted and nothing is left.
3. **Obsolescence:** Some assets are discarded before they are worn out because of changed conditions. For example, an old machine which is still workable may have to be replaced by a new machine because of the latter being more efficient and economical. Such a loss on account of new inventions or changed fashions is termed as loss on account of obsolescence.

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4. **Efflux of time:** Certain assets get decreased in their value with the passage of time. This is true in case of assets like leasehold properties, patents or copyrights.
5. **Accidents:** An asset may meet an accident and, therefore, it may get depreciated in its value.

   On the basis of the above causes, it can be said that depreciation is the decrease or depletion in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident.

10.2.2 Basic Features of Depreciation

1. The term 'depreciation' is used only in respect of fixed assets. Of course, the current assets may also lose their value. Loss on account of fall in their value is taken care of by valuing them for Balance Sheet purposes "at cost or market price whichever is less".
2. Depreciation is a charge against profits. This means that true profit of the business cannot be ascertained without charging depreciation.
3. Depreciation is different from maintenance. Maintenance expenses are incurred for keeping the machine in a state of efficiency. However, any degree of maintenance cannot assure that the asset will never reach a state of scrap. Of course, good maintenance delays this stage but it cannot absolutely prevent it.
4. All fixed assets, with certain possible exceptions, *e.g.,* land, and antiques etc., suffer depreciation although the process may be invisible or gradual.

Depreciation

The term 'depreciation' is to be distinguished from other terms such a depletions, amortization etc. though they are used often interchangeably.

Depletion: Depletion implies removal of an available but irreplaceable resource such as extracting coal from a coal mine or oil out of an oil well.

Amortization: The process of writing off intangible assets is termed as amortization. Some intangible assets like patents, copyrights, leaseholds have a limited useful life. Hence, their cost must be written off over such period.

The American Institute of Certified Public Accountants (AICPA) has put the difference between depreciation, depletion, and amortization in the following words.

"Depreciation can be distinguished from other terms with specialised meaning used by accountants to describe assets cost allocation procedures. Depreciation is concerned with charging the cost of man made fixed assets to operations (and not with determination of asset value for the balance sheet). Depletion refers to cost allocations for natural resources such as oil and mineral deposits. Amortization relates to cost allocation for intangible assets such as patent and leaseholds. The use of the term depreciation should also be avoided in connection with the valuation procedures for securities and investments.”

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Dilapidations: The term dilapidation refers to damage done to a building or other property during tenancy. When a property is taken on lease, is returned to the landlord he may ask the lessee as per agreement to put it in as good condition as it was at the time it was leased out. In order to meet cost of such dilapidation, a provision may be created by debiting the property account with the estimated amount of dilapidation and crediting the provision for dilapidations account. Depreciation may then be charged on the total cost of the asset so arrived at. Any payment made later on dilapidation may be debited to the provision for dilapidation account. The balance, if any, may be transferred to profit and loss account.

10.2.3 Meaning of Depreciation Accounting

Depreciation Accounting is mainly concerned with a rational and systematic distribution of cost over the estimated useful life of the asset. According to the American Institute of Certified Public Accountants, Depreciation Accounting is ‘a system of accounting which aims to distribute the cost or other basic values of the tangible capital assets less salvage (if any) over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is the process of allocation and not of valuation”.

The objective of Depreciation Accounting is to absorb the cost of using the assets to different accounting periods in a way so as to give the true figure of profit or loss made by the business.

10.2.4 Objectives of Providing Depreciation

The following are objectives of providing depreciation:

1. **Ascertainment of true profits** When an asset is purchased, it is nothing more than a payment in advance for an expense. For example, if a building is purchased for ₹10,000 for business, the effect of such a purchase will be saving in the cost of rent in the future. But, after a certain number of years, the building will become useless. The cost of the building is, therefore, nothing except paying rent in advance for a period of years. If the rent had been paid, it would have been charged as an expense for determination of the true profits, made by the business during a particular period. The amount paid for the purchase of building should, therefore, be charged over a period of time for which the asset would be serviceable.
2. **Presentation of true financial position** The assets get depreciated in their value over a period of time on account of various factors, as explained before. In order to present a true state of affairs of the

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business, the assets should be shown in the Balance Sheet, at their proper values.

3. **Replacement of assets** Assets used in the business need replacement after the expiry of their service life. By providing depreciation a part of the profits of the business is kept in the business which can be used for purchase of new assets on the old fixed assets becoming useless.

10.2.5 Fixation of Depreciation Amount

Following are the three important factors which should be considered for determining the amount of depreciation to be charged to the Profit and Loss Account in respect of a particular asset.

1. **Cost of the asset** The cost of the asset includes the invoice price of the asset, less any trade discount plus all costs essential to bring the asset to a usable condition. It should be noted that financial charges, such as interest on money borrowed for the purchase of the asset, should not be included in the cost of the asset.
2. **Estimated scrap value** The term scrap value means the residual or the salvage value which is estimated to be realised on account of the sale of the asset at the end of its useful life. In determining the scrap value, the cost to be incurred in the disposal or removing of the asset should be deducted out of the total realisable value.
3. **Estimated useful life** This is also termed as economic life of the asset. This may be calculated in terms of years, months, hours, units of output of other operating measures such as kilometres in case of a taxi or a truck.

10.2.6 Methods of Recording Depreciation

Depreciation can be recorded in the books of accounts by two different methods:

1. **When a provision for depreciation account is maintained** In case of this method, the amount of depreciation to be charged in a particular year is credited to Provision for Depreciation Account and debited to Profit and Loss Account. The Asset Account appears in the books at original cost. In case the asset is sold, the Provision for Depreciation Account is transferred to the Asset Account. Any amount realised on account of sale of the asset is also credited to the Asset Account. The balance, if any, in the Asset Account is transferred to the Profit and Loss Account.

The following journal entries are passed in case this method is followed:

(*i*) For providing depreciation:

Depreciation Account Dr.

To Depreciation Account

(*ii*) For transfer of depreciation to Profit and Loss Account:

Profit and Loss Account Dr.

To Depreciation Account

(*iii*) On sale of asset:

(*a*) Provision for Depreciation Account Dr.

To Asset Account

(*b*) In case of profit or loss on sale of an asset:

If Profit: Asset Account Dr.

To Profit and Loss Account

If Loss: Profit and Loss Account Dr.

To Asset Account

Alternatively, on sale of an asset, an 'asset disposal account' may be opened. The following entries will be passed in such a case on sale of an asset:

Asset Disposal Account Dr.

To Asset Account

(with original cost of asset)

Bank Account Dr.

To Asset Disposal Account

(with the actual sale proceeds on account of sale of asset)

Provision for Depreciation Account Dr.

To Asset Disposal Account

(with the accumulated depreciation on the asset sold)

Profit & Loss Account Dr.

To Asset Disposal

(for transfer of loss on sale of the asset)

In case of profit, the above entry would be reversed.

2. **When a provision for depreciation account is not maintained** In case a provision for Depreciation Account is not maintained, the amount of depreciation is debited to the Depreciation Account and credited to the Asset Account. The Asset Account thus appears in the books at a written down value (*i.e.,* the value remaining after deducting depreciation). The Depreciation Account is transferred to the Profit and Loss Account like any other item of expense.

The following journal entries are passed in case depreciation is provided according to this method:

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(*i*) For providing depreciation:

Depreciation Account Dr.

To Asset Account

(*ii*) For transfer of depreciation to the Profit and Loss Account:

Profit and Loss Account Dr.

To Depreciation Account

In case the asset is sold, the amount realised is credited to the Asset Account. Any profit or loss on the sale of the asset is transferred to the Profit and Loss Account.

Check Your Progress

1. What is amortization?
2. What does the cost of the asset include?

10.3 METHODS FOR PROVIDING DEPRECIATION

There are various methods of providing depreciation. Important ones are discussed here.

10.3.1 Uniform Charge Methods: Straight Line Method or Fixed Instalment Method

In case of these methods depreciation is charged on uniform basis year after year. Such methods are considered appropriate only for such assets which are uniformly productive.

The following three methods fall in this category.

Fixed instalment method

This is also termed as Straight Line Method (*SLM*). According to this method, depreciation is charged evenly every year throughout the effective life of the asset. The amount of depreciation is calculated as follows:

$$\text{Depreciation} = \frac{\text{Original Cost of the Fixed Asset} - \text{Estimated Scrap Value}}{\text{Life of the Asset in Number of Accounting Periods}}$$

or

$$D = \frac{C - S}{N}$$

The depreciation to be charged each year can also be expressed as a percentage of cost. This percentage (R) can be calculated as follows:

$$R = \frac{D}{C} \times 100$$

or

For example, if an asset has been purchased for ₹10,000 and it will have a scrap value of ₹1,000 at the end of its useful life of 10 years, the amount of depreciation to be charged every year over the effective life of the asset will be computed as follows:

$$\text{Depreciation} = \frac{10,000 - 1,000}{10 \text{ years}}$$

= ₹900 each year and Rate of Depreciation (R) 9%

Merits (*i*) The method is simple to understand and easy to apply.

(*ii*) The value of the asset can be reduced to zero (or its scrap value) under this method.

(*iii*) The method is very suitable, particularly in case of those assets which get depreciated more on account of expiry of period, *e.g.*, leasehold properties, patents, etc.

Demerits (*i*) The method does not take into account the effective utilisation of the asset. The same amount of depreciation is charged from year to year irrespective of the use of the asset.

(*ii*) The total charge for use of the asset (*i.e.*, depreciation and repairs) goes on increasing from year to year though the asset might have been used uniformly from year to year. For example, in the initial years, the amount spent on repairs is quite normal. It goes on increasing in the later years. The amount of depreciation remains the same for each year. Thus, each subsequent year is burdened with greater charge for the use of asset on account of increasing cost on repairs.

(*iii*) The method tends to report an increasing rate of return on investment in the asset on account of the fact that net balance of the asset account is taken. For example, if the cost of an asset is ₹10,000, life 10 years, net revenue before charging depreciation ₹2,000, the earnings for the first three years will be calculated as follows:

	Year 1	*Year 2*	*Year 3*
	₹	₹	₹
Revenue	2,000	2,000	2,000
Less: Depreciation	1,000	1,000	1,000
Profit	1,000	1,000	1,000
Book Value of the asset			
(capital employed)	10,000	9,000	8,000
Rate of Return	10%	11.1%	12.5%

The idea of an increasing rate of return as an asset approaches retirement does not seem to be justifiable. Reason suggests that the rate of return either remains constant or actually decreases somewhat as the asset ages.

Illustration 10.1. A firm purchases a plant for a sum of ₹10,000 on Ist January, 2013. Installation charges are ₹2,000. Plant is estimated to have a scrap value of ₹1,000 at the end of its useful life of five years. You are required to prepare Plant Account for five years charging depreciation according to Straight Line Method.

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Solution:

PLANT ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
Jan. 1.	To Bank	12,000	Dec. 31	By Depreciation A/c	2,200
			Dec. 31	By Balance c/d	9,800
		12,000			12,000
2014			2014		
Jan. 1.	To Balance b/d	9,800	Dec. 31	By Depreciation A/c	2,200
			Dec. 31	By Balance c/d	7,600
		9,800			9,800
2015			2015		
Jan. 1.	To Balance b/d	7,600	Dec. 31	By Depreciation A/c	2,200
			Dec. 31	By Balance c/d	5,400
		7,600			7,600
2016			2016		
Jan.1.	To Balance b/d	5,400	Dec. 31	By Depreciation A/c	2,200
			Dec. 31	By Balance c/d	3,200
		5,400			5,400
2017			2017		
Jan. 1.	To Balance b/d	3,200	Dec. 31	By Depreciation A/c	2,200
			Dec. 31	By Balance c/d	1,000
		3,200			3,200

Illustration 10.2. A firm writes off 95% of the cost of machinery acquired over a period of 10 years by the straight line method, leaving 5% as estimated scrap value. Full depreciation is written off even if the machinery is in use only for part of a year. On 31st March, 2015, the original cost of the machinery was as follows:

	₹
Purchased in 2004-05 or earlier	1,20,000
Purchased in 2006-07	40,000
Purchased in 2010-11	30,000

On 30th September, 2015, a machine which had cost of ₹10,000 in 2003-04 was disposed of for ₹900; and on 28th February, 2016, a machine acquired in 2010-11 at a cost of ₹15,000 was sold for ₹5,000. On the same date, a new machinery was acquired for ₹45,000.

Prepare the machinery account for the year 2015-16, the accounts being closed on 31st March each year.

Solution:

Dr. MACHINERY ACCOUNT Cr.

Date	Particulars	₹	Date	Particulars		₹
2015			2015			
Apr. 1	To Balance b/d (*WN*1)	27,550	Sept. 30	by Bank		900
Sept. 30	To P & L A/c (Profit)	400				
2016			2016			
Feb. 28	To Bank	45,000	Feb. 28	By Bank		5,000
			Feb. 28	By Depreciation		1,425
			Feb. 28	By *P* & *L* A/c (Loss)		1,450
			Mar. 31	By Depreciation A/c:		
				Machine purchased in		
				2000-01	3,800	
				2004-05	1,425	
				2009-10	4,275	9,500
				By Balance c/d		54,675
		72.950				72,950
2017						
Apr. 1	To Balance b/d	54,675				

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Working Notes:

		₹	₹
1.	Computation of Opening Balance of Machinery Account on 1st April, 2015:		
	Machinery purchased in 2004-05 or earlier:		
	At Scrap Value, *i.e.,* 5% of ₹1,20,000		6,000
	Machinery purchased in 2006-07:		
	Scrap Value: *i.e.,* 5% of ₹40,000	2,000	
	Add: Balance of Depreciation for one year		
	₹(40,000 – 2,000) × 1/10	3,800	5,800
	Machinery purchased in 2010-11:		
	Scrap value: *i.e.,* 5% of ₹30,000	1,500	
	Add: Balance of Depreciation for 5 years		
	₹(30,000 – 1,500) × 5/10	14,250	15,750
	Balance of Machinery A/c as on 1.4.2015		27,550
2.	Computation of Machinery on 30th Sept. 2015:		
	Sale of Machinery on 30th Sept. 2015		900
	Less: Book Value of Machinery *i.e.,* Scrap Value: 5% of ₹10,000		500
	Profit on sale of Machinery		400
3.	Depreciation on Machinery sold on 28th Feb. 2016:		
	Depreciation for one year ₹(15,000 – 750) × 1/10		1,425
4.	Loss on sale of machinery on 28th Feb., 2016:		
	Book Value on 1st April, 2015 ₹750 + (15,000 – 750) × 5/10		7,875
	Less: Depreciation for the year ₹(15,000 – 750) × 1/10		1,425
			6,450
	Less: Sale Proceeds of Machine		5,000
	Loss on sale of Machine		1,450
5.	Depreciation on Machinery purchased on 28th Feb., 2016:		

$$\frac{45{,}000 - 2{,}250}{10} = \frac{42{,}750}{10} = ₹4{,}275$$

(*b*) **Depletion method** This is also known as productive output method. According to this method the charge for depreciation in respect of the use of an asset will be based on the following factors:

(*i*) Total amount paid.

(*ii*) Total estimated quantities of the output available.

(*iii*) The actual quantity taken out during the accounting year.

The method is suitable in case of mines, queries, etc., where it is possible to make an estimate of the total output likely to be available. Depreciation is calculated per unit of output. The amount of depreciation to be charged in a particular year is computed by multiplying the unit of output with the rate of depreciation per unit of output. For example, if a mine is purchased for ₹20,000 and it is estimated that the total quantity of mineral in the mine is 40,000 tonnes, the rate of depreciation per tonne would amount to 50 paise per tonne (₹20,000/40,000 tonnes). In case output in a year amounts to 10,000 tonnes, the amount of depreciation to be charged to the Profit and Loss Account would ₹5,000 (*i.e.,* 10,000 tonnes × ₹0.50).

The method has the advantage of correlating the amount of depreciation with the productive use of the asset. However, it requires making of a reasonably correct estimate of the output likely to be there. In the absence of correct estimate, the amount charged by way of depreciation will not be correct.

(*c*) **Machine hour rate method** This is also known as Service Hours Method. This method takes into account the running time of the asset for the purpose of calculating depreciation. The method is particularly suitable for charging depreciation on plant and machinery, aircraft, etc. The amount of depreciation is calculated as follows:

$$\frac{\textbf{Original Cost of the Asset} \quad \textbf{Scrap Value}}{\textbf{Life of the Asset in hours}}$$

For example, if a machine (having a scrap value of ₹1,000) is purchased for ₹20,000 and it has an effective life of 10 years of 1,000 hours each, the amount of depreciation per hour will be computed as follows:

$$\text{Depreciation} = \frac{\text{Original Cost} \quad \text{Scrap Value}}{\text{Life of the Asset in hours}}$$

$$= (₹10{,}000 - ₹1{,}000)/10{,}000 \text{ hours}$$

$$= ₹0.90$$

This means that, there will be a depreciation of 90 paise in case machine runs for an hour. If, in a particular year, the machine runs for 600 hours, the amount of depreciation will be ₹540 (*i.e.,* ₹90 × 600).

The method has the advantage of correlating the charge for depreciation, to the actual working time of the machine. However, this method can be used only in case of those assets whose life can be measured in terms of working time.

10.3.2 Declining Charge Depreciation Methods: Diminishing Balance Method

In case of these methods the amount charged for depreciation declines over the asset's expected life. These methods are suitable in those case where (*a*) the receipts are expected to decline as the asset gets older and (*b*) it is believed that the allocation of depreciation should be related to the pattern of asset's expected receipts.

The diminishing balance method falls in this category.

According to diminishing balance method, depreciation is charged on the book value of the asset each year. Thus, the amount of depreciation goes on decreasing every year. For example, if the cost of an asset is ₹20,000, and the rate of depreciation is 10%, the amount of depreciation to be charged in the first year will be a sum of ₹2,000. In the second year, depreciation will be charged at 10% on the book value of the asset, (*i.e.,* ₹20,000 – ₹2,000) and so on.

The formula for calculating the rate of depreciation under diminishing balance method (where 'n' = years of economic life of the asset) is as follows:

$$\text{Depreciation Rate} = 1 - n\sqrt{\frac{\text{Net Residual Value}}{\text{Acquisition Cost}}}$$

For example, if the cost of an asset is ₹10,000, residual value ₹1,296, economic life 4 years, the rate of depreciation would be 40% calculated as follows:

$$\text{Depreciation rate} = 1 - 4\sqrt{\frac{1{,}296}{10{,}000}}$$

$$= 1 - 6/10 = 40\%$$

Merits

(*i*) The method puts an equal burden for use of the asset on each subsequent year. The amount of depreciation goes on decreasing for each subsequent year while the charge for repairs goes on increasing for each subsequent year. Thus, increase in the cost of repairs for each subsequent year is compensated by decrease in the amount of depreciation for each subsequent year.

(*ii*) The method is simple to understand and easy to follow.

Demerits

(*i*) The value of the asset cannot be brought down to zero under this method.

(*ii*) The determination of a suitable rate of depreciation is also difficult under this method as compared to the Fixed Instalment Method.

Straight Line Method and Diminishing Balance Method

The difference between straight line method and diminishing balance method can be put as follows:

(*a*) *Amount on depreciation:* In case of straight line method, the amount of depreciation remains same throughout the life of the asset. While in case of diminishing balance method, the amount of depreciation is more during the earlier years of the life of the asset as compared to

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the later years. Thus, the amount of depreciation charged every year is not the same.

(*b*) *Value on expiry of the life of the asset:* In case of straight line method, the value of the asset on expiry of its life becomes zero. While in case of diminishing balance method, the value at the end of the life of the asset would never become zero.

(*c*) *Overall charge for the use of the asset:* In case of fixed instalment method, the overall charge for use of the asset goes on increasing because of fixed amount of depreciation plus increasing cost of repairs year after year. While in case of diminishing balance method, the overall cost for use of the asset almost remains the same year after year. This is because of decrease in the amount of depreciation and increase in the cost of repairs.

Illustration 10.3. A firm purchases plant and machinery on 1st January, 2015 for ₹10,000. Prepare the Plant Account for three years charging depreciation @ 10% p.a. according to the Diminishing Balance Method.

Solution:

PLANT AND MACHINERY ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2015			2015		
Jan. 1	To Bank	10,000	Dec. 31	By Depreciation	1,000
			Dec. 31	By Balance c/d	9,000
		10,000			10,000
2016			2016		
Jan. 1	To Balance b/d	9,000	Dec. 31	By Depreciation	900
			Dec. 31	By Balance c/d	8,100
		9,000			9,000
2017			2017		
Jan. 1	To Balance b/d	8,100	Dec. 31	By Depreciation	810
Dec. 31	By Balance c/d	7,290			
		8,100			8,100

10.3.3 Sinking Fund Method

One of the objectives of providing for depreciation (as explained earlier) is to provide for replacement of the asset at the end of its useful life. In case of the three methods discussed earlier, the amount of depreciation charged from the Profit & Loss Account continues to remain in the business. However, this amount may get invested in the course of running the business is some other assets. It may, therefore, not be possible for the business to have sufficient liquid resources to purchase a new asset at the time when it needs funds for replacement. Depreciation Fund Method takes care of such a contingency. According to this method, the amount charged by way of depreciation is invested in certain securities carrying a particular rate of interest. The amount received on account of interest from these securities is also invested from time to time together with the annual amount charged by way of depreciation.

At the end of the useful life of the asset, when replacement is required, the securities are sold away and money realised on account of the sale of the securities is used for purchase of a new asset. The method has the advantage of providing a separate sum for replacement of the asset. However, the method has a disadvantage. It puts an increasing burden on the profit and loss of each year on account of a fixed charge for depreciation but increasing charge for repairs.

The accounting entries are as follows:

(*a*) *At the end of the 1st accounting year*

(*i*) On setting aside the amount for depreciation:

Depreciation Account (or Profit & Loss Account) Dr.

To Depreciation Fund Account

(The amount to be charged by way of depreciation is determined on the basis of Sinking Fund Table)

(*ii*) For investing the money charged by way of depreciation:

Depreciation Fund Investment A/c Dr.

To Bank

(*b*) *At the end of each subsequent accounting year*

(*iii*) For receipt of interest

Bank A/c Dr.

To Depreciation Fund A/c

(Interest will be received at the specified rate on balance of Depreciation Fund Investment outstanding in the beginning of each year)

(*iv*) For setting aside the amount of depreciation:

Profit and Loss A/c Dr.

To Depreciation Fund A/c

(*v*) For investing the money:

Depreciation Fund Investment A/c Dr.

To Bank

(Annual instalment plus interest received)

(*c*) *At the end of the last year*

(*vi*) For receipt of interest:

Bank A/c Dr

To Depreciation Fund A/c

(*vii*)For setting aside the amount for depreciation:

Profit and Loss A/c

To Depreciation Fund A/c

(No investment will be made at the end of the last year since the asset is due for replacement and no purpose will be served by simply investing the money and then selling the investment either on the same day or on the subsequent day.)

(*viii*) For the sale of investments:

Bank A/c Dr.

To Depreciation Fund Investment A/c

(*ix*) The profit or loss on sale of Depreciation Fund Investments will be transferred to the Depreciation Fund Account.

(*x*) For sale of the old asset:

Bank A/c Dr.

To Asset Account

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(*xi*) The balance in the Depreciation Fund represents accumulated depreciation. It will be transferred to the Old Asset Account.

(*xii*) The balance in the Old Asset Account represents profit or loss. It will be transferred to the Profit and Loss Account.

(*xiii*) The proceeds realised on account of sale of the asset and investment will be utilised for purchase of new asset.

New Asset A/c Dr.

To Bank

Illustration 10.4. Suresh bought a plant on 1.1.2013 for a sum of ₹1,00,000 having a useful life of 5 years. It is estimated that the plant will have a scrap value of ₹16,000 at the end of its useful life. Suresh decides to charge depreciation according to depreciation fund method. The depreciation fund investments are expected to earn interest @ 5% p.a. Sinking Fund table shows that ₹0.180975 if invested yearly at 5% p.a. produces ₹1 at the end of 5 years. The investments are sold at the end of 5th year for a sum of ₹65,000. A new plant is purchased for ₹1,20,000 on 1.1.2018. The scrap of the old plant realises ₹17,000.

You are required to prepare the necessary accounts in the books of Suresh.

Solution:

PLANT ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
Jan. 1	To Bank	1,00,000	Dec. 31	By Balance c/d	1,00,000
2014			2014		
Jan. 1	To Balance b/d	1,00,000	Dec. 31	By Balance c/d	1,00,000
2015			2015		
Jan. 1	To Balance b/d	1,00,000	Dec. 31	By Balance c/d	1,00,000
2016			2016		
Jan. 1	To Balance b/d	1,00,000	Dec. 31	By Balance c/d	1,00,000
2017			2017		
Jan. 1	To Balance b/d	1,00,000	Dec. 31	By Depreciation Fund A/c	83,478
Dec. 31	To P. & L. A/c (Profit)	478	Dec. 31	By Bank (Scrap sold)	17,000
		1,00,478			1,00,478

NEW PLANT ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2018					
Jan.1	To Bank A/c	1,20,000			

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DEPRECIATION FUND ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
2013			2013		
Dec. 31	To Balance c/d	15,202	Dec. 31	By *P.* & *L.* A/c	15,202
2014			2014		
Dec. 31	To Balance c/d	31,164	Jan. 1	By Balance b/d	15,202
			Dec. 31	By Bank (Interest)	760
			Dec. 31	By *P.* & *L.* A/c	15,202
		31,164			31,164
2015			2015		
Dec. 31	To Balance c/d	47,924	Jan. 1	By Balance b/d	31,164
			Dec. 31	By Bank (Interest)	1,558
			Dec. 31	By *P.* & *L.* A/c	15,202
		47,924			47,924
2016			2016		
Dec. 31	To Balance c/d	65,522	Jan. 1	By Balance b/d	47,924
			Dec. 31	By Bank (Interest)	2,396
			Dec. 31	By *P.* & *L.* A/c	15,202
		65,522			65,522
2017			2017		
Dec. 31	To Depreciation Fund Investment A/c (loss on sale of investment)	522	Jan. 1	By Balance b/d	65,522
			Dec. 31	By Bank (Interest)	3,276
			Dec. 31	By *P.* & *L.* A/c	15,202
Dec. 31	To Plant A/c (accumulated depreciation)	83,478			
		84,000			84,000

DEPRECIATION FUND INVESTMENT ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
2013			2013		
Dec. 31	To Bank	15,202	Dec. 31	By Balance c/d	15,202
		15,202			15,202
2014			2014		
Jan. 1	To Balance b/d	15,202	Dec. 31	By Balance c/d	31,164
Dec. 31	To Bank (15,202 + 760)	15,962			
		31,164			31,164
2015			2015		
Jan. 1	To Balance b/d	31,164	Dec. 31	By Balance c/d	47,924
Dec. 31	To Bank (15,202 + 1,558)	16,760			
		47,924			47,924
2016			2016		
Jan. 1	To Balance b/d	47,924	Dec. 31	By Balance c/d	65,522
Dec. 31	To Bank (15,202 + 2,396)	17,598			
		65,522			65,522
2017			2017		
Jan. 1	To Balance b/d	65,522	Dec. 31	By Bank	65,000
				By Depreciation Fund A/c (loss on sale of investment)	522
		65,522			65,522

Note: The amount to be charged to the Profit and Loss Account has been arrived as follows:

Original Cost of the Plant	1,00,000
Less: Estimated scrap value	16,000
Depreciation on the plant for its whole life	84,000

The amount to be charged to the
Profit and Loss Account = ₹84,000 × 0.180975 = ₹15,201.90 or ₹15,202

Illustration 10.5. On 1st July, 2016 a company purchased a Plant for ₹20,000. Depreciation was provided at 10% per annum on straight line method on 31st December every year. With effect from 1.1.2016, the company decided to change the method of depreciation to Diminishing Balance Method @ 15% p.a. On 1.7.2017, the plant was sold for ₹12,000. Prepare Plant Account from 2014 to 2017.

Solution:

PLANT ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
July 1	To Cash	20,000	Dec. 31	By Depreciation	1,000
			Dec. 31	By Balance c/d	19,000
		20,000			20,000
2015			2015		
Jan. 1	To Balance b/d	19,000	Dec. 31	By Depreciation	2,000
			Dec. 31	By Balance c/d	17,000
		19,000			19,000
2016			2016		
Jan. 1	To Balance b/d	17,000	Dec. 31	By Depreciation	2,550
				By Balance c/d	14,450
		17,000			17,000
2017			2017		
Jan. 1	To Balance b/d	14,450	June 31	By Dep. (for 6 months)	1,084
			July 1	By Cash	12,000
			July 1	By *P* and *L* A/c	1,366
		14,450			14,450

Illustration 10.6. On the basis of the information given in Illustration 10.6, prepare Plant Account from 2014 to 2017, if the firm decides on 1.1.2016 to charge depreciation according to Diminishing Balance Method w.e.f. 1.7.2014 and to make adjustments for arrears of depreciation in the year 2016.

Solution:

PLANT ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
July 1	To Cash	20,000	Dec. 31	By Depreciation	1,000
			Dec. 31	By Balance c/d	19,000
		20,000			20,000
2015			2015		
Jan. 1	To Balance b/d	19,000	Dec. 31	By Depreciation	2,000
			Dec. 31	By Balance c/d	17,000
		19,000			19,000
2016			2016		
Jan. 1	To Balance b/d	17,000	Dec. 31	By Depreciation arrears (for 2014 & 2015)	1,275
			Dec. 31	By Dep. (for 2016)	2,359
			Dec. 31	By Balance c/d	13,366
		17,000			17,000
Jan. 1	To Balance b/d	13,366	June 30	By Dep. (for 6 months)	1,002
			July 1	By Bank (Sale)	12,000
			July 1	By *P* & *L* A/c (loss on sale)	364
		13,366			13,366

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Working Notes:

1. Adjustment for arrears of depreciation in 2016.

Year	*Fixed Instalment Method*	*Diminishing Balance Method*
2014 (for half year)	1,000	1,500
2015	2,000	2,775
	3,000	4,275

Extra depreciation to be charged in 2016 is ₹1,275 on account of change in the method of depreciation.

2. Depreciation for 2016 on ₹15,725 at 15% comes to ₹2,359.

Illustration 10.7. A firm purchased a plant for ₹10,000 on 1.1.2013. It was charging depreciation at 10% p.a. according to the fixed instalment method. At the end of 2017, the firm decided to change the method of depreciation from the Fixed Instalment Method to the Diminishing Balance Method w.e.f. 1.1.2014. The rate of depreciation was to be at 12% p.a. You are required to prepare the Plant Account for the three years ending 31st December, 2017 and also show how the depreciation item would appear in the Profit and Loss Account of the year 2017.

Solution:

COMPUTATION OF DEPRECIATION

Fixed Instalment Method			*Diminishing Balance Method*		
Year	*Book value of the asset*	*Depreciation*	*Year*	*Book value of the asset*	*Depreciation*
2014	10,000	1,000	2014	10,000	1,200
2015	9,000	1,000	2015	8,800	1,056
2016	8,000	1,000	2016	7,744	929
		3,000			3,185

From the above figures, it is clear that on account of change in the method of depreciation ₹185 will have to be charged as extra depreciation for the last 3 years in the year 2017 besides the usual depreciation for the year. In 2017, the depreciation will be charged according to the Diminishing Balance Method which comes to ₹818 on the book value of ₹6,815 (*i.e.,* ₹7,744 – ₹929). The Plant Account can now be prepared as follows.

PLANT ACCOUNT

Date	*Particulars*	*₹*	*Date*	*Particulars*	*₹*
2014			2014		
Jan. 1	To Bank	10,000	Dec. 31	By Depreciation	1,000
				By Balance c/d	9,000
		10,000			10,000
Jan. 1	To Balance b/d	9,000	Dec. 31	By Depreciation	1,000
				By Balance c/d	8,000
		9,000			9,000
2016			2016		
Jan. 1	To Balance b/d	8,000	Dec. 31	By Depreciation	1,000
				By Balance c/d	7,000
		8,000			8,000
2017			2017		
Jan. 1	To Balance b/d	7,000	Dec. 31	By Depreciation (extra for 2014-2016)	185

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				By Depreciation for 2017 (according to the Diminishing Balance Method)	818
				By Balance c/d	6,997
		7,000			7,000

PROFIT AND LOSS ACCOUNT
for the year ending 31.12.2017

Dr *Cr.*

Date	*Particulars*		₹	*Date*	*Particulars*	₹
	To Depreciation for 2017	818				
	Add : Additional depreciation for 2014 to 2016 on account of change to Diminishing Balance Method from Fixed Instalment Method	185	1,003			

Illustration 10.8. A firm purchased on 1st January, 2014 certain Machinery for ₹58,200 and spent ₹1,800 on its erection. On 1st July, 2014 additional machinery costing ₹20,000 was purchased. On 1st July, 2016 the machinery purchased on 1st January, 2014 having become obsolete was auctioned for ₹28,600 and on the same date fresh machinery was purchased at a cost of ₹40,000.

Depreciation was provided for annually on 31st December at the rate of 10 per cent on written down value. In 2017, however, the firm changed this method of providing depreciation on the original cost of the machinery.

Give the Machinery Account as it would stand at the end of each year from 2014 to 2017.

Solution:

MACHINERY ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
Jan. 1	To Cash (58,200 + 1,800)	60,000	Dec. 31	By Depreciation (6,000 + 1,000)	7,000
July 1	To Cash	20,000		By Balance c/d	73,000
		80,000			80,000
2015			2015		
Jan. 1	To Balance b/d	73,000	Dec. 31	By Depreciation	7,300
				By Balance c/d	65,700
		73,000			73,000
2016			2016		
Jan. 1	To Balance b/d	65,700	July 1	By Cash (sale price)	28,600
July 1	To Cash	40,000		By Depreciation on Machine sold	2,430
				By *P* & *L* A/c	17,570
				By Dep. (1,710 + 2,000)	3,710
				By Balance c/d	53,390
		1,05,700			1,05,700
2017			2017		
Jan. 1	To Balance b/d	53,390	Dec. 31	By Dep. @ 5% on original cost of machines (₹20,000 + ₹40,000)	3,000
				By Balance c/d	50,390
		53,390			53,390

NOTES

Note. Loss on the machinery purchased on Jan. 1, 2014.

	₹
Cost Price	60,000
Less: Depreciation for 2014	6,000
	54,000
Less: Depreciation for 2015	5,400
	48,600
Less: Depreciation for 2016 (6 months)	2,430
Book Value on July 1, 2016	46,170
Less: Sales Value	28,600
Loss on sale	17,570

Illustration 10.9. On 1st April, 2013 a new plant was purchased for ₹40,000 and a further sum of ₹2000 was spent on its installation.

On 1st October, 2015 another plant was acquired for ₹25,000.

Due to an accident on 3rd January, 2016 the first plant was totally destroyed and the remnants were sold for ₹1,000 only.

On 21st January, 2017 a second hand plant was purchased for ₹30,000 and a further sum of ₹5,000 was spent for bringing the same to use on and from 15th March, 2017.

Depreciation has been provided at 10 per cent on straight line basis. It was a practice to provide depreciation for full year on all acquisition made at any time during any year and to ignore depreciation on any item sold or disposed of during the year. None of the assets were insured. The accounts are closed annually to 31st March.

It is now decided to follow the rate of 15 per cent on diminishing balance method with retrospective effect in respect of the existing items of plant and to make the necessary adjustment entry on 1st April, 2017.

Show the journal entries to be passed for the purpose and the Plant Account and the Depreciation Provision Account for all the years.

Solution:

PLANT ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2014		
April 1	To Bank (Cost & Instal.)	42,000	Mar. 31	By Balance c/d	42,000
2014			2015		
April 1	To Balance b/d	42,000	Mar. 31	By Balance c/d	42,000
2015			2016		
April 1	To Balance b/d	42,000	Jan. 3	By Bank	1,000
Oct. 1	To Bank	25,000	Mar. 3	By Dep. Provision A/c	8,400
				By Profit & Loss A/c	32,600
				By Balance c/d	25,000
		67,000			67,000
2016			2017		
April 1	To Balance b/d	25,000	Mar. 3	By Balance c/d	60,000
2017					
Jan. 21	To Bank	30,000			
	To Bank	5,000			
		60,000			60,000

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PROVISION FOR DEPRECIATION ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
2014			2014		
Mar. 31	To Balance c/d	4,200	Mar. 31	By Depreciation (10% on 42,000)	4,200
2015			2014		
Mar. 31	To Balance c/d	8,400	April 1	By Balance b/d	4,200
			2015		
			Mar. 31	By Depreciation	4,200
		8,400			8,400
2016			2015		
Jan. 3	To Plant A/c	8,400	April 1	By Balance b/d	8,400
Mar. 31	To Balance c/d	2,500	2016		
			Mar. 31	By Depreciation A/c	2,500
		10,900			10,900
2017			2016		
Mar. 31	To Balance c/d	8,500	April 1	By Balance b/d	2,500
			Mar. 12	By Depreciation A/c	6,000
		8,500			8,500
			2017		
			April 1	By Balance b/d	8,500
				By Depreciation (additional)	3,687

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Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2017				
April 1	Depreciation A/c Dr.		3,687	
	To Provision for Depreciation A/c			3,687
	(Being the provision made for the additional amount of depreciation required due to the change in the basis of depreciation to 15% on reducing balance method with retrospective effect)			

Working Note:

		Cost	Depreciation (2015-16)	Depreciation (2016-17)	Total
		₹	₹	₹	₹
Plant Purchased in :	2015-16	25,000	3,750	3,187	6,937
	2016-17	35,000	—	5,250	5,250
			3,750	8,437	12,187
Provision already existing					8,500
Additional Provision required					3,687

Illustration 10.10. Giri Raj Enterprises purchased second hand machinery on 1st April, 2013 for ₹3,70,000 and installed at a cost of ₹30,000. On 1st October, 2014, it purchased another machine for ₹1,00,000 and on 1st October, 2015, it sold off the first machine purchased in 2013 for ₹2,80,000.

On the same date it purchased a machinery for ₹2,50,000. On 1st October, 2016, the second machinery purchased for ₹1,00,000 was sold off for ₹20,000.

In the beginning depreciation was provided on machinery at the rate of 10% p.a. on the original cost each year on 31st March. From the year 2014-15, however, the trader changed the method of providing depreciation and adopted the written down value method, the rate of depreciation being 15% p.a.

Give the Machinery Account for the period 2013 to 2017.

Solution:

In the Books of Giri Raj Enterprises

MACHINERY ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
2013			2014		
April 1	To Bank A/c	3,70,000	Mar. 31	By Depreciation A/c	
	To Bank (Exp.)	30,000		(10% on ₹4,00,000)	40,000
				By Balance c/d	3,60,000
		4,00,000			4,00,000
2014			2015		
April 1	To Balance b/d	3,60,000	Mar. 31	By Depreciation A/c	
Oct. 1	To Bank	1,00,000		(15% on ₹3,60,000	54,000
				& 15% on ₹1,00,000	7,500
				for 6 months)	
				By Balance c/d	3,98,500
				(₹3,06,000 + 92,500)	
		4,60,000			4,60,000
2015			2015		
April 1	To Balance b/d	3,98,500	Oct. 1	By Bank A/c	2,80,000
	(₹3,06,000 + 92,500)			By Depreciation A/c	
Oct. 1	To Bank A/c	2,50,000		(15% on ₹3,06,000	22,950
				for 6 months)	
				By *P* & *L* A/c	3,050
				(Loss on Sale)	
			2016		
			Mar. 31	By Depreciation A/c	
				(15% on ₹92,500 &	13,875
				15% on ₹2,50,000	18,750
				for 6 months)	
				By Balance c/d	
				(₹78,625 + 2,31,250)	3,09,875
		6,48,500			6,48,500
2016			2016		
April 1	To Balance b/d	3,09,875	Oct. 1	By Bank A/c	20,000.88
	(₹78,625 + 2,31,250)			By Depreciation A/c	
				(15% on ₹78,625	
				for 6 months)	5,896.88
				By *P* & *L* A/c	
				(Loss on Sale)	52,728.12
			2017		
			Mar. 31	By Depreciation A/c	34,687.50
				(15% on ₹2,31,250)	
				By Balance c/d	1,96,562.50
		3,09,875.00			3,09,875.00

Working Notes:

(1) *Loss on sale of machine on 1.10.2015*

	₹	₹
Written down value on 1.4.2015		3,06,000
Less: Depreciation for 6 months	22,950	
Sale price	2,80,000	3,02,950
Loss on sale		3,050

(2) *Loss on sale of machine on 1.10.2016*

	₹	₹
Written down value on 1.4.2016		78,625.00
Less: Depreciation for 6 months	5,896.88	
Sale price	20,000.00	25,896.88
Loss on sale		52,728.12

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Check Your Progress

3. List the different declining charge or accelerated depreciation methods.
4. Define the sum of the years digits method.
5. State the disadvantage of the depreciating (or sinking) fund method.

10.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Amortization is the process of writing off intangible assets.
2. The cost of the asset includes the invoice price of the asset, less nay trade discount plus all costs essential to bring the asset to a usable condition.
3. The different declining charge or accelerated depreciation methods are: Diminishing balance method, sum of the years digits method and double declining method.
4. The sum of the years digit method is on the pattern of diminishing balance method. The amount of depreciation to be charged to the Profit and Loss Account under this method goes on decreasing every year.
5. The disadvantage of the depreciating (or sinking) fund method is that it puts an increasing burden on the profit and loss of each year on account of a fixed charge for depreciation but increasing charge for repairs.

10.5 SUMMARY

- Depreciation may, therefore, be defined as that portion of the cost of the assets that is deducted from revenue for assets services used in the operation of a business. Depreciation is thus allocating the cost of assets to the business over the useful life of the asset. It is thus a process of allocation and not of valuing the assets.
- There are varied causes of depreciation: wear and tear, exhaustion, obsolescence, efflux of time and accidents.
- Features of depreciation include: The term 'depreciation' is used only in respect of fixed assets, Depreciation is a charge against profits, Depreciation is different from maintenance and all fixed assets, with certain possible exceptions, e.g., land, and antiques etc., suffer depreciation although the process may be invisible or gradual.
- Depletion implies removal of an available but irreplaceable resource such as extracting coal from a coal mine or oil out of an oil well.
- The process of writing off intangible assets is termed as amortization. Some intangible assets like patents, copyrights, leaseholds have a

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limited useful life. Hence, their cost must be written off over such period.

- The term dilapidation refers to damage done to a building or other property during tenancy. When a property is taken on lease, is returned to the landlord he may ask the lessee as per agreement to put it in as good condition as it was at the time it was leased out.
- Depreciation Accounting is mainly concerned with a rational and systematic distribution of cost over the estimated useful life of the asset. The objective of Depreciation Accounting is to absorb the cost of using the assets to different accounting periods in a way so as to give the true figure of profit or loss made by the business.
- The objective of depreciation accounting are: ascertainment of true profits, presentation of true financial position, replacement of assets.
- Three important elements are considered for determining the amount of depreciation to be charged to the Profit and Loss Account in respect of a particular asset: cots of the asset, estimated scrap value, and estimated useful life.
- The methods of recording depreciation include: when a provision for depreciation account in maintained and when a provision for depreciation account is not maintained.
- The major methods for providing depreciation are: Uniform charge methods, declining charge methods and other methods.
- Uniform charge methods include: (a) Fixed instalment method, (b) Depletion method and (c) Machine hour rate method.
- Declining charge or accelerated depreciation methods: (a) Diminishing balance method, (b) Sum of years digits method and (c) Double declining method.
- Other methods: (a) Group depreciation method, (b) Inventory system of depreciation, (c) Annuity method (d) Depreciation fund method and (e) Insurance policy method.

10.6 KEY WORDS

- **Amortization:** The process of writing off the intangible assets.
- **Depletion:** The portion of the cost of the natural resources recognised as an expense for each period.
- **Depreciation:** The portion of the cost of tangible operating assets (other than land) recognised as an expense for each period.
- **Depreciation Accounting:** A system of accounting which aims to distribute the cost or other basic values of tangible capital assets (less salvage, if any) over the estimated useful life of the asset in a systematic and rational manner.

- **Dilapidation:** Damage done to a building or other property during the tenancy.

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10.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answers Questions

1. State the need and significance of depreciation?
2. What factors should be considered for determining amount of depreciation?
3. Write short notes on:
   (a) Group Depreciation Method;
   (b) Double Declining Balance Method; and
   (c) Accounting Standard 6 (Revised): Depreciation Accounting.
   (d) Depreciation Fund
4. What is Depreciation?
5. State the merits and demerits of Sinking Fund Method of depreciation.

Long Answers Questions

1. Distinguish between "straight line method" and "diminishing balance method" of providing depreciation. Which one of the above two methods would you recommend to provide depreciation on Plant and Machinery?
2. Explain the circumstances under which different methods of depreciation can be employed.
3. What do you mean by "replacement cost"? What are the difficulties faced while providing depreciation on the basis of replacement lost.
4. Explain the salient features of accounting standard regarding dpreciation as per AS: 10 Property, Plant and Equipment.

10.8 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

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BLOCK - III
TYPES OF BRANCHES OF ACCOUNTING

UNIT 11 ACCOUNTING FOR CONSIGNMENTS AND JOINT VENTURES

Structure

11.0 INTRODUCTION

Joint Venture and Consignment are different methods of doing business. If co-venturers consign goods to each other or to third parties, then such transaction can be called as Joint Consignment. It is different from consignment.

11.1 OBJECTIVES

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

- Differentiate between sale and consignment
- Describe the important terms of a consignment account
- Differentiate between consigner's book and consignee's book
- Pass appropriate accounting entries in the books of consignee
- Describe the process of accounting for joint ventures

11.2 CONSIGNMENTS

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 distances. 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 (Principal) risk for an agreed amount of commission. Such a despatch of goods from one person to another person at a different place for the purpose of warehousing and ultimate sale is termed as consignment. Goods so sent are termed as 'Goods sent on Consignment', the sender is called "Consignor" and the recipient is called "Consignee".

For example if *A* of Mumbai sends 100 radio sets to *B* of Delhi to sell on his (*A*'s) behalf and at his (*A*'s) risk, the transaction between *A* and *B* is a consignment transaction. *A* is the 'consignor' and *B* is the 'consignee'.

It should be noted that in the above example, *A* continues to be the owner of the goods. *B* is simply an agent of *A*. He has not purchased the goods. He has agreed to sell the goods of *A* to the best of his ability and capacity. He will, therefore, be responsible to *A* for payment only when he has sold away the goods. Of course, he will be reimbursed by *A* for any expenses incurred by him in obtaining and selling the goods besides remuneration for selling the goods as per the agreed terms.

The main features of a consignment transaction can now therefore be put as follows:

(*i*) Consignment of goods is not a sale. It is mere transfer of possession of goods.

(*ii*) The consignee sells goods at the risk of the consignor. He is not responsible for any loss or destruction of goods.

(*iii*) The sale proceeds belong to the consignor and the consignee merely gets commission and expenses that he might have incurred.

(*iv*) The relationship between consignor and consignee is that of a Principal and an Agent.

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*) *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.

(*c*) *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.

(*d*) *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.

Important Terms

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 in 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 an Account Sales.

Account Sales of 50 transistors ex S.S. San Pedro received and sold on account of Robbins & Sons, Chicago by:

M/S CHIMAN LAL DESAI & CO. MUMBAI

Particulars		₹	₹
40 transistors at ₹1,200 per transistor		48,000.00	
10 transistors at ₹1,100 per transistor		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) Ashoka Kumar

Mumbai, the 15th Jan. 2012 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.

NOTES

In order to give further incentive, sometimes an extra commission termed as over-riding commission is allowed to consignee, in case the sales exceed a specified 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.

Illustration 11.1. Gopi Cycles (P) Ltd., Hyderabad, sent 2,000 dynamos costing ₹50 each for sale on consignment basis to Ramoo of Vijaywada, subject to the following terms:

(*i*) Normal selling price per dynamo ₹60;

(*ii*) Consignee's commission to be calculated as under:

- (*a*) 5 per cent on normal selling price;
- (*b*) 1 per cent additional commission if selling price is more than normal price; and
- (*c*) ½ per cent del-credere commission on total sales for guaranteeing collection of credit sales.

Ramoo reported sales as follows:

	₹
Cash Sales:	
500 dynamos at ₹60 each	30,000
200 dynamos at ₹75 each	15,000
Credit Sales:	
400 dynamos at ₹75 each	30,000
400 dynamos at ₹80 each	32,000
Total	1,07,000

Ascertain the commission due to consignee.

Solution:

STATEMENT OF COMMISSION DUE TO CONSIGNEE

	₹
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 × ½/100	535
	5,805

Illustration 11.2 Goods costing ₹ 6,30,000 were sent out to consignee at a profit of 20 per cent on invoice price. Consignee sold 2/3rd goods for ₹ 6,00,000. Consignee was entitled to an ordinary commission of 3 per cent on sales at invoice price and over-riding commission of 20 per cent of any surplus realized. Calculate the amount of consignee's commission and give the journal entry for it in the books of the consignor.

Solution:

Invoice value of goods sold = $6,30,000 \times \frac{2}{3} \times \frac{100}{(100-20)}$ = ₹ 5,25,000

Surplus of Sale value over invoice value = 6,00,000 – 5,25,000 = ₹ 75,000

Consignee Commission:

		₹
Ordinary	$₹5,25,000 \times \frac{3}{100}$	= 15,750
Over-riding	$₹75,000 \times \frac{20}{100}$	=15,000
Total Commission		= 30,750

In the Books of the Consignor

Consignee Commission:

Consignment A/c	Dr.	30,750	
To Consignee's A/c			30,750

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 expenses are freight, carriage, insurance, loading and unloading charges etc.

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. This has been explained in detail later.

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. For example, if the value of goods sent on consignment is to be ₹50,000, and the consignee is asked to deposit (say) 10 per cent of the value of goods to be sent, the amount of advance will be ₹5,000. This covers to certain extent the risk of the consignor. 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 ₹50,000 are sent on consignment to *A* who sells away 50 per cent of the goods for ₹40,000. Consignor required that 10 per cent of the value of the goods should be kept as an advance with him. *A*'s expenses and commission amount to ₹5,000. The amount to be sent by *A* will be calculated as follows:

	₹	₹
Sales Value of the goods		40,000
Less : Commission and Expenses	5,000	
Advance deposited 10 per cent of ₹25,000	2,500	7,500
Amount to be sent by *A*		32,500

Thus, 10 per cent of the value stock lying with the consignee i.e., ₹2,500 out of initial advance of ₹5,000 will still remain as advance with the consignor till these goods are finally sold.

11.2.1 Accounting Records: Consigner's Book and Consignee's Book

A proper record of all transactions relating to a particular consignment is necessary for ascertaining Net Profit or Net Loss on each separate consignment. To attain this objective the consignor usually maintains three accounts:

(1) Consignment Account.

(2) Consignee's Account.

(3) Goods Sent on Consignment Account.

Consignment Account is a Nominal Account. It is in fact a special Trading and Profit & Loss Account and, therefore, its balance shows the Profit or Loss made on a particular consignment.

Consignee's Account is a Personal Account and, therefore, in case the Consignee has not remitted the balance due by him in full, he will be a debtor, whereas if he has remitted more than the balance due by him, he will be a creditor.

Goods sent on Consignment Account is a Real Account. It is closed up by transferring its balance to Purchases Account (sometimes it is also transferred to the credit side of Trading Account).

The above accounts are maintained in respect of each of the consignments. For example, if goods have been sent on Consignment to Mumbai, Kolkata and Chennai, Consignment Account, Consignee's Account and Goods sent on Consignment Account will be maintained in respect of each of these consignments.

NOTES

Pricing of Goods Sent on Consignment

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 price to the consignor. The proforma invoice is also prepared at this price. For example if the goods costing ₹10,000 are purchased by *A* and 80 per cent of such goods are sent by him on consignment to Mumbai, proforma invoice will show the value of goods as ₹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 (*see Illustration 11.3*).

At invoice price In case of this method the goods are charged to the consignment at a price higher than cost. The proforma invoice also shows the value of goods at such higher price. The excess of invoice price over the actual cost, represents the profit which the consignor intends to make on the goods consigned. For example, if in the above case the goods are consigned at a profit of 25 per cent on cost (or 20 per cent on invoice price), the consignment account will be charged with ₹10,000 (*i.e.,* ₹8,000 + ₹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 ₹2,000. Thus, in fact, consignment account has been charged only with the cost (*i.e.,* ₹10,000 – ₹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 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.

Accounting Entries in the Books of Consignor

The accounting entries to be recorded in the books of the consignor in both the cases are being explained in the following pages.

NOTES

Book of Consignor

JOURNAL ENTRIES

	Transaction	*Debit*	*Credit*
(1)	When Security is asked	Bank or Cash or B/E.	Consignee's A/c.
(2)	When goods are sent:	Consignment A/c.	Good sent on Consignment A/c.
	(*a*) at cost.		(with cost price)
	(*b*) at Invoice Price.	(*i*) Consignment A/c.	Goods sent on Consignment A/c. (at invoice price)
	In order to bring down the goods sent on consignment to cost, an adjustment entry will be necessary.	(ii) Goods sent on Consignment A/c. (with the difference between invoice price and cost price)	Consignment A/c.
(3)	For expenses incurred by the consignor.	Consignment A/c.	Cash A/c.
(4)	When goods are received by the consignee.	No entry	
(5)	When Account Sales is received from the consignee:		
	(*a*) for sales made by Consignee.	Consignee's A/c.	Consignment A/c.
	(*b*) for expenses incurred by Consignee.	Consignment A/c.	Consignee's A/c.
	(*c*) for commission.	Consignment A/c.	Consignee's A/c.
(6)	If bad debts incur and consignee is a del-credere agent.	No entry	
(7)	When bad debts take place and consignee is not a del-credere agent.	Consignment A/c.	Consignee's A/c. (because he was debited with total sales)
	Transaction	Debit	Credit
(8)	For stock in the hands of the consignee:	Stock on	Consignment A/c.
	(*a*) If the goods were sent at cost.	Consignment A/c. (with cost price)	
	(*b*) If the goods were sent in invoice price.	(*i*) Stock on Consignment A/c. (with invoice price)	Consignment A/c.
	In order to write-off the unrealised profit on stock an adjusting entry will be necessary.	(*ii*) Consignment A/c. (with the difference between invoice price of stock and cost price)	Stock Reserve A/c.
	The balance of Stock Reserve A/c will be carried to the *B/S* and will be deducted from the value of stock on consignment. In the following period, the consignment stock of last period will be transferred to the debit side of the consignment account. The stock reserve on such stock will be transferred to the credit side of that account.		
(9)	For settlement of accounts with the consignee		
	(*i*) If the consignee owes money he will pay it in cash or send B/E etc.	Bank/Cash or B/E.	Consignee's A/c.
	(*ii*) If the consignor owes money to the consignee, he will pay him in cash or send B/E.	Consignee's A/c.	Cash or B/E A/c.
	(in case accounts are not settled the		

	Transaction	Debit	Credit
	balance of Consignee's Account will be carried forward).		
(10)	If the B/E received from the consignee is discounted.	Bank A/c Discount A/c.	B/E A/c.
(11)	The discount A/c is closed by transferring it to P & L A/c.	P & L A/c.	Discount A/c.
(12)	The consignment account will be closed by transferring the balance (*i.e.,* Profit or Loss) to P & L A/c.		
	(*a*) In case of profit.	Consignment A/c.	P & L A/c.
	(*b*) In case of a large number of consignment accounts, a separate 'Profit & Loss on Consignment A/c' can be opened. Profit or Loss on each individual Consignment A/c will be transferred to this account and ultimately the balance of this account will be transferred to P & L A/c.	For loss a reverse entry will be passed	
(13)	Goods sent on Consignment A/c will be closed by transferring its balance to Purchases or Trading A/c.	Goods sent on Consignment A/c.	Purchases A/c or Trading A/c.
(14)	"Consignment Stock A/c" will appear as an asset in the Balance Sheet.		

Illustration 11.3. On 1st April, 2016, Aditya Mills Ltd., Delhi, consigns 500 pieces of shirting costing ₹5,000 to Birla Stores, Mumbai. The consignee is entitled to 5% selling commission and 1% del-credere commission.

Following expenses were incurred by the consignor:

	₹
Carriage	200
Insurance	100
Freight	150

Aditya Mills Ltd. draws a Bill of Exchange for ₹2,000 on Birla Stores, Mumbai, which was duly accepted by them. It is discounted for ₹1,950.

On 31st May, 2016, Birla Stores send the Account Sales which shows that they have sold goods for ₹7,500 and paid expenses amounting to ₹150. Stock in Consignee's hands on 31st May, 2016 is valued at ₹1,500.

Birla Stores enclose a sight draft with the Account Sales, for the net amount due to Aditya Mills Ltd. Give journal entries and ledger accounts in the books of the consignor.

Solution:

NOTES

JOURNAL

Date	Particulars		Dr. (₹)	Cr. (₹)
2016 April	Consignment to Mumbai A/c	Dr.	5,000.00	
	To Goods Sent on Consignment A/c			5,000.00
	(500 pieces of shirting consigned to Birla Stores, Mumbai)			
	Consignment to Mumbai A/c	Dr.	450.00	
	To Cash A/c			450.00
	(Expenses incurred: Carriage ₹200, Insurance ₹100, and Freight ₹150)			
	Bills Receivable A/c	Dr.	2,000.00	
	To Birla Stores, Mumbai A/c			2,000.00
	(Bills of exchange received from Birla Stores, Mumbai)			
	Bank A/c	Dr.	1,950.00	
	Discount A/c	Dr.	50.00	
	To Bills Receivable A/c			2,000.00
	(Bills Receivable discounted for ₹1,950)			
	Consignment to Mumbai A/c	Dr.	150.00	
	To Birla Stores A/c			150.00
	(Expenses incurred by the consignee in connection with consignment)			
	Consignment to Mumbai A/c	Dr.	450.00	
	To Birla Stores, Mumbai A/c			450.00
	(Commission due to Birla Stores, Mumbai being ordinary @ 5% and del-credere @ 1% on ₹7,500)			
	Birla Stores Ltd. A/c	Dr.	7,500.00	
	To Consignment to Mumbai A/c			7,500.00
	(Being sales made)			
	Stock on Consignment A/c	Dr.	1,500.00	
	To Consignment to Mumbai A/c			1,500.00
	(Stock with consignee)			
Dec. 31	Goods Sent on Consignment A/c	Dr.	5,000.00	
	To Trading A/c			5,000.00
	(Being transfer of goods sent on consignment to Trading A/c)			
	Bills Receivable A/c	Dr.	4,900.00	
	To Birla Stores Ltd. A/c			4,900.00
	(B/R received for net balance due)			
	Consignment to Mumbai A/c	Dr.	2,950.00	
	To *P & L* A/c			2,950.00
	(Transfer of the profit on consignment)			
Dec. 31	*P & L* A/c	Dr.	50.00	
	To Discount A/c			50.00
	(Discount written off)			

NOTES

Ledger Accounts

Dr. CONSIGNMENT TO MUMBAI ACCOUNT *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2016			2016		
April	To Goods sent on Consignment	5,000.00	May 31	By Birla Stores, Mumbai	7,500.00
				By Stock on Consignment	1,500.00
	To Cash (Expenses)	450.00			
	To Birla Stores, Mumbai (Expenses)	150.00			
May 31	To Birla Stores, Mumbai (Commission)	450.00			
	To *P* & *L* A/c (transfer of Profit)	2,950.00			
		9,000.00			9,000.00

BIRLA STORES, MUMBAI ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
Jan 31	To Bank	1,60,020	Jan 1	By Balance b/d	
2016			2016		2,26,000
	To Consignment A/c (Sale proceeds)	7,500.00	April	By Bills Receivable A/c	2,000.00
				By Consignment A/c (Expenses)	150.00
				By Consignment A/c (Commission)	450.00
				By B/R	4,900.00
		7,500.00			7,500.00

Dr. GOODS SENT ON CONSIGNMENT ACCOUNT *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
Jan 31	To Bank	1,60,020	Jan 1	By Balance b/d	
2016			2016		2,26,000
Dec. 31	To Consignment A/c	5,000.00	April	By Consignment A/c	5,000.00

Accounting Entries in the Books of Consignee

Illustration 11.4. On the basis of data given below, pass the Journal entries and prepare the necessary accounts in the books of the Consignee. (*A* & Co. of Kolkata sent on consignment account goods to *B* & Co. of Mumbai at an invoice price of ₹29,675 and paid for freight ₹762, cartage ₹232 and insurance ₹700. Half the goods were sold by agents for ₹17,500, subject to the agent's commission of ₹875, storage expenses of ₹200 and other selling expenses of ₹350. One-fourth of the consignment was lost by fire and a claim of ₹5,000 was recovered.)

NOTES

Solution:

JOURNAL

	Particulars		Dr. (₹)	Cr. (₹)
	A & Co., Kolkata	Dr.	550	
	To Bank A/c			550
	(Expenses incurred in connection with receipt of Consignment from *A* & Co.)			
	Bank A/c	Dr.	17,500	
	To *A* & Co.			17,500
	(*A* & Co. credited for sales proceeds)			
	A & Co. Kolkata	Dr.	875	
	To Commission A/c			875
	(For commission earned)			
	A & Co., Kolkata	Dr.	16,075	
	To Bills Payable A/c			16,075
	(Bills payable accepted in settlement of account)			
	Bills Payable A/c	Dr.	16,075	
	To Bank A/c			16,075
	(Payment made on maturity)			

Dr. *A* & CO., KOLKATA *Cr.*

Particulars	₹	Particulars	₹
To Bank (expenses)	550	By Bank	17,500
To Commission	850		
To Bill Payable A/c	16,075		
	17,500		17,500

BILLS PAYABLE ACCOUNT

Particulars	₹	Particulars	₹
To Bank	16,075	By *A* & Co., Kolkata	16,075

COMMISSION ACCOUNT

Particulars	₹	Particulars	₹
To *P* & *L* A/c	875.00	By *A* & Co., Kolkata	875.00

BANK ACCOUNT

Particulars	₹	Particulars	₹
To *A* & Co., Kolkata	17,500	By *A* & Co., Kolkata A/c	550
		By Bills Payable	16,075
		By Balance c/d	875
	17,500		17,500

11.3 ACCOUNTING FOR JOINT VENTURES

A joint venture is an association of two or more than two persons who have combined for the execution of a specific transaction and divide the profit or loss thereof in the agreed ratio. For example, if *A* and *B* undertake the job of construction of a school building for a sum of ₹1,00,000 their coming together for this specific job will be termed as a joint venture and each one of them will be termed as a co-venturer. The venture will be over as soon as this transaction is over *i.e.,* the school building is completed. Joint venture agreements can be made for similar other transactions, *e.g.,* joint consignment of goods, underwriting of the shares or debentures issued by a particular company, purchasing and selling of a specific property etc.

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.

Joint Venture and Partnership

According to the Indian Partnership Act, "Partnership is the relations 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. Of course, 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'.

Joint Venture and Consignment

The difference between Joint Venture and Consignment can be put as follows:

(*a*) *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.

(*b*) *Sharing of Profits* In case of joint venture, the profits 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.

(*c*) *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.

(*d*) *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.

(*e*) *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.

Accounting Records

There are three ways in which Joint Venture Accounts can be kept. They are as follows:

1. When *Separate Set of Books* for the venture are maintained. This will be necessary when venture is of a large magnitude.
2. When *One Venturer* keeps the accounts. 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 venturer.
3. When *All Venturers* keep accounts. 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.

In the following pages each of these methods, has been discussed in detail.

When Separate Set of Books are Maintained

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
(1) When venturers contribute cash to the joint funds.	Joint Bank A/c (with total amt.)	Venturer's A/c (with individual contribution separately)
(2) When amount is spent on account of expenses, or for purchasing goods for the venture.	Joint Venture A/c	Joint Bank A/c
(3) If any expenses are paid by the venturers.	Joint Venture A/c	Venturer's A/c
(4) For Sales:		
(*i*) Cash	Joint Bank A/c	Joint Venture A/c
(*ii*) Credit	Sundry Drs. A/c	Joint Venture A/c
(5) If Stock is taken by a venturer.	Venturer's A/c	Joint Venture A/c
(6) If any stock remains unsold.	Joint Venture Stock A/c	Joint Venture A/c
(7) Balance of the Joint Venture A/c will be either profit or loss.		
(*i*) If profit	Joint Venture A/c	Venturers A/c
(*ii*) If loss	Venturer's A/c	Joint Venture A/c
(8) Joint Bank account and personal accounts of Venturers' will be automatically closed by introduction or withdrawal of cash.		

Illustration 11.5. Banerjee and Mukherjee agree to import Russian timber into India. On 1st July, 2016 they opened a joint bank account with ₹25,000 towards which Banerjee contributed ₹15,000 and Mukherjee contributed ₹10,000. They agree to share profits and losses in proportion to their cash contributions.

They remitted to their agent in Russia ₹20,000 to pay for timber purchased, and later ₹2,100 in settlement of his account. Freight, insurance and dock charges amounted to ₹3,900. On Dec. 31, 2016 the sales amounted to ₹28,740 which enabled them to repay themselves with cost originally advanced, (no account to be taken of interest). They then decided to close the venture and Mukherjee agreed to take over the timber unsold for ₹1,260, which is to be deducted from his share of profit.

Prepare the necessary accounts showing the amount of cash available for division by way of profits and how the same is divisible between Banerjee and Mukherjee.

Solution:

JOINT VENTURE ACCOUNT

Particulars	₹	Particulars	₹
To Joint Bank A/c	20,000	By Joint Bank A/c (Sales)	28,740
To Joint Bank A/c		By Mukherjee	1,260
(commission of agent)	2,100		
To Joint Bank A/c			
(freight and insurance)	3,900		
To Profit transferred to:			
Banerjee 3/5	2,400		
Mukherjee 2/5	1,600		
	30,000		30,000

NOTES

JOINT BANK ACCOUNT

Particulars	₹	*Particulars*	₹
To Banerjee	15,000	By Joint Venture A/c	20,000
To Mukherjee	10,000	By Joint Venture A/c	2,100
To Joint Venture A/c	28,740	By Joint Venture A/c	3,900
		By Banerjee	17,400
		By Mukherjee	10,340
	53,740		53,740

BANERJEE

Particulars	₹	*Particulars*	₹
To Joint Bank A/c	17,400	By Joint Bank A/c	15,000
		By Joint Venture A/c	2,400
	17,400		17,400

MUKHERJEE

Particulars	₹	*Particulars*	₹
To Joint Venture A/c	1,260	By Joint Bank A/c	10,600
To Joint Bank A/c	10,340	By Joint Venture A/c	1,600
	11,600		11,600

Illustration 11.6. 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 ₹1,00,000 payable as to ₹80,000 by instalment in cash and ₹20,000 in fully paid shares of the Company. A bank account is opened in their joint names, Prakash paying in ₹50,000 and Suresh ₹25,000. They are to share profit or loss in the proportion of 2/3 and 1/3 respectively. Their transactions were as follows:

	₹
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 ₹16,000.

Prepare the Joint Venture Account, showing profit or loss, and the accounts of Prakash and Suresh showing the final distribution.

NOTES

Solution:

JOINT VENTURE ACCOUNT

Particulars		₹	*Particulars*	₹
To Joint Bank A/c (wages)		30,000	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				
Prakash	10,000			
Suresh	5,000	15,000		
		96,000		96,000

JOINT BANK ACCOUNT

Particulars	₹	*Particulars*	₹
To Prakash	50,000	By Joint Venture A/c	30,000
To Suresh	25,000	By Joint Venture A/c	40,000
To Joint Venture A/c	80,000	By Prakash	51,000
		By Suresh	34,000
	1,55,000		1,55,000

PRAKASH

Particulars	₹	*Particulars*	₹
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's fees)	2,000
		By Joint Venture A/c (profit)	10,000
	67,000		67,000

SURESH

Particulars	₹	*Particulars*	₹
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
	34,000		34,000

When One Venturer Keeps Accounts

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.

JOURNAL ENTRIES

Sl. No	Transaction	Debit	Credit
1.	When the working partner receives from other co-venturers their share of investment	Cash/Bank	Venture's A/c
2.	When goods are purchased.	Joint Venture A/c	Cash or Crs. A/c

Sl. No	Transaction	Debit	Credit
3.	When expenses for the venture are incurred.	Joint Venture A/c	Cash A/c
4.	When goods are sold.	Cash or Drs. A/c	Joint Venture A/c
5.	When he is allowed an extra commission for his services.	Joint Venture A/c	Commission A/c (later on transferred to his *P* & *L* A/c)
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.	Joint Venture A/c	*P* & *L* A/c
	(*ii*) The shares of co-venturers will be transferred to their respective personal accounts.	Joint Venture A/c	Individual A/cs of the co-venturers.
	(*iii*) The venturers accounts will then show what is due to them in respect of their investments and their share of profit or loss.		

Illustration 11.7. 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 ₹60,000 to B incurring expenses amounting to ₹2,000 for freight and insurance. During transit goods costing ₹5,000 became damaged and a sum of ₹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 ₹1,000. B had earlier remitted an advance of ₹10,000. B duly paid the balance due to A by draft.

You are required to prepare in *A*'s books:

(*i*) Joint Venture Account. (*ii*) *B*'s account.

Solution:

Books of *A*

JOINT VENTURE ACCOUNT

Particulars	₹	Particulars	₹
To Purchases (Cost of goods suppld.)	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:			
P & *L* A/c	5,648		
B	2,824		
	71,896		71,896

B's ACCOUNT

Particulars	₹	Particulars	₹
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
		By Joint Venture A/c (Commission)	424
		By Joint Venture A/c (Share of profit)	2,824
		By Bank (Balance received)	54,648
	68,896		68,896

Working Notes:

1. It has been assumed that the goods damaged in-transit have no residual value.
2. 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
Profits 30%	14,850
Sales	64,350

3. 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

When All Venturers Keep Accounts

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.

(*ii*) When such information is furnished at the completion of the venture. This is popularly known as 'memorandum method'.

1. *When each Venturer gets complete information from other Venturer(s).* In this case each party maintains the following accounts:

(*i*) ***Joint Venture Account.*** It is similar to an ordinary *P* & *L* A/c. 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.

(*ii*) ***Personal Account or Accounts of the Co-venturers.*** 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 from 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 settling the balance.

The Journal entries to be passed in case of this method are given below:

JOURNAL ENTRIES

Sl. No	*Transaction*	*Debit*	*Credit*
(1)	When goods are brought or money is spent on Joint Venture.	Joint Venture A/c	Seller's A/c or Bank A/c
(2)	When he receives a report that his co-venture has bought goods or spent money on the Joint Venture.	Joint Venture A/c	Co-venturers Personal A/c
(3)	When he sells goods bought on Joint Venture A/c	Cash A/c or Purchasers A/c	Joint Venture A/c
(4)	When he receives a report that his co-venturer has sold goods bought on Joint Venture A/c.	Co-venturers A/c	Joint Venture A/c

Sl. No	*Transaction*	*Debit*	*Credit*
(5)	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.		
(6)	The personal account of the co-venturer when balanced will show what is due from him or what is due to him.		

Illustration 11.8. *X* and *Y* entered into a joint venture of underwriting the subscription at par of the entire share capital of Copper Mines Limited consisting of 10,000 shares of ₹10 each and to pay all expenses up to allotment. They were to share profits in the ratio of 3 : 2 respectively. The consideration in return for the guarantee was 1,200 other shares of ₹10 each fully paid to be issued to them.

X provided the funds for registration fees ₹1,200; advertising ₹1,100 and printing and stationery ₹950. *Y* contributed towards payment of office rent ₹300; legal charges ₹1,550 and staff salaries ₹900.

The prospectus was issued and the applications fell short of the full issue by 1,500 shares. *X* took these over on joint account and paid for the same in full. They received the 1,200 fully paid shares as underwriting commission. They sold their entire holding at ₹12 per share. The proceeds were received by *X* for 1,500 shares and by *Y* for 1,200 shares.

Write up the necessary accounts in the books of both the parties showing the final adjustment.

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Solution:

In the Books of *Y*

JOINT VENTURE ACCOUNT

Particulars	₹	*Particulars*	₹
To Bank (Registration Fee)	1,200	By *Y* (Sales)	14,400
To Bank (Advertising)	1,100	By Bank (Sales)	18,000
To Bank (Printing and Stationery)	950		
To *Y* (Office Rent)	300		
To *Y* (Legal Charges)	1,550		
To *Y* (Staff Salaries)	900		
To Bank (Shares)	15,000		
To Profit:			
P & *L* A/c	6,840		
Y	4,560		
	32,400		32,400

Y's ACCOUNT

Particulars	₹	*Particulars*	₹
To Joint Venture A/c	14,400	By Joint Venture A/c (Office Rent)	300
		By Joint Venture A/c (Legal charges)	1,550
		By Joint Venture A/c (Salaries)	900
		By Joint Venture A/c (Profit)	4,560
		By Bank	7,090
	14,400		14,400

In the Books of *Y*

JOINT VENTURE ACCOUNT

Particulars	₹	*Particulars*	₹
To X	1,200	By Bank	14,400
To X	1,100	By *X*	18,000
To X	950		
To Bank	300		
To Bank	1,550		
To Bank	900		
To *X*	15,000		
To Profit			
P & *L* A/c	4,500		
X	6,840		
	32,400		32,400

X's ACCOUNT

Particulars	₹	*Particulars*	₹
To Joint Venture A/c	18,000	By Joint Venture A/c	1,200
To Bank A/c	7,090	By Joint Venture A/c	1,100
		By Joint Venture A/c	950
		By Joint Venture A/c	15,000
		By Joint Venture A/c	6,840
	25,090		25,090

Check Your Progress

1. State the main features of a consignment transaction.
2. What is a proforma invoice?
3. What are direct expenses?

11.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The main features of a consignment transaction can now therefore be put as follows:
   - Consignment of goods is not a sale. It is mere transfer of possession of goods.
   - The consignee sells goods at the risk of the consignor. He is not responsible for any loss or destruction of goods.
2. It is a statement prepared by the consignor stating quantity, quality and price of goods. It is sent with goods despatched to consignee.
3. Direct expenses 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.

11.5 SUMMARY

- 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 distances. 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 (Principal) risk for an agreed amount of commission.
- Such a despatch of goods from one person to another person at a different place for the purpose of warehousing and ultimate sale is termed as consignment. Goods so sent are termed as 'Goods sent on Consignment', the sender is called "Consignor" and the recipient is called "Consignee".
- 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.
- 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.

- Proforma invoice is a statement prepared by the consignor stating quantity, quality and price of goods. It is sent with goods despatched to consignee.
- 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.
- A proper record of all transactions relating to a particular consignment is necessary for ascertaining Net Profit or Net Loss on each separate consignment. To attain this objective the consignor usually maintains three accounts:
  - o Consignment Account.
  - o Consignee's Account.
  - o Goods Sent on Consignment Account.
- A joint venture is an association of two or more than two persons who have combined for the execution of a specific transaction and divide the profit or loss thereof in the agreed ratio.
- According to the Indian Partnership Act, "Partnership is the relations between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."

11.6 KEY WORDS

- **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 divide the profit or loss thereof in the agreed ratio.
- **Consignment account:** It is a Nominal Account. It is in fact a special Trading and Profit & Loss Account and, therefore, its balance shows the Profit or Loss made on a particular consignment.
- **Consignee's account:** It is a Personal Account and, therefore, in case the Consignee has not remitted the balance due by him in full, he will be a debtor, whereas if he has remitted more than the balance due by him, he will be a creditor.

11.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Differentiate between direct and indirect expenses.
2. What are the ways in which goods can be sent on consignment?
3. Differentiate between joint venture and accounting.

Long Answer Questions

1. Pass appropriate entries in the books of a consignor.
2. With the help of an illustration, pass appropriate accounting entries in the books of consignee.
3. Analyse the three accounts maintained by a consignor.
4. Describe the three ways in which joint venture accounts can be kept.

11.8 FURTHER READINGS

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UNIT 12 INVESTMENT AND ROYALTY ACCOUNT

NOTES

Structure

12.0 INTRODUCTION

A firm may hold a large number of investments in the form of different types of securities. In such a case it is desirable to keep a separate account for each security so that profit or loss transactions relating to a particular security can be ascertained and all interests and dividends are properly accounted for. For this purpose, the firm may keep an investment ledger in which a separate account may be opened for each type of security. The account may provide for columns regarding date, face value, interest, and principal amount of securities. While recording transactions in the investment ledger, particular care has to be taken of interest or dividend received or paid by the company.

12.1 OBJECTIVES

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

- Understand the concept of royalty, minimum rent and shortworkings
- Identify the accounting problems concerned with recouping shortworkings and sub-lease
- Make appropriate accounting entries concerning various aspects of royalty transactions
- Explain the meaning of certain key terms

12.2 CUM-INTEREST AND EX-INTEREST, CUM-DIVIDEND AND EX-DIVIDEND

NOTES

Interest on securities or dividend on shares for a particular period is payable only to those persons whose names appear in the company's records. Since shares, debentures, etc. are generally freely transferable, the company closes the register of members of debenture holders for a certain period by giving a sufficient public notice to that effect. The closure of the Register means that the company will not entertain any application for transfer during this period. In other words, the relevant dividend or interest will be paid to persons whose names appear in the company's Register of Shareholders or Debentureholders, as the case may be, during such period.

A purchaser of debentures or shares can receive the interest due on debentures or dividend declared on shares from the company only when he gets the delivery of the debentures or shares from the seller sufficiently before (generally before 10 clear days) the closure of the Register of Members. In case he gets delivery in time, he can get his name entered in the company's records and receive the interest due or dividend declared for the full period. Since in this case the seller loses the interest/dividend for the period which he held the securities, he charges, besides the price of securities, any consideration for the interest or dividend lost. For example, if *A* sells on 1st May 6% debentures of ₹ 10,000 on which interest is payable on 30th June and 31st December, he will charge from the buyer not only the price for the debentures but also for the 4 months interest lost by him. Similarly, in case of shares, if the dividend has been declared, the seller will lose the dividend if he sells the shares and the buyer gets his name registered with the company before closure of the register of members. The price quoted by the seller may, therefore, be inclusive or exclusive of interest/dividend. In the former case, it is termed as a cum-interest or a cum-dividend price; in the latter case, it is termed as an ex-interest or ex-dividend price.

In actual practice, the terms cum-interest and ex-interest are not used in case of price quoted in the stock exchange regarding debentures, government bonds, etc. As a matter of fact, the price quoted in respect of these securities is always presumed to be exclusive of interest. This means that the buyer will have to pay to the vendor, besides price for debentures, interest for the period the debentures were held by the vendor. He will get full period interest on the due date. However, if, on account of insufficient time, the buyer is not in a position to get his name recorded in the company's register of debentureholders, the delivery of the debenture and payment of the price is postponed to a day which falls after the period during which the register of debenture holders will remain closed. Thus, the buyer has not to pay for any interest to the seller which the buyer could receive from the company otherwise.

In case of shares, cum-dividend price means price inclusive of dividend declared by the company in respect of the relevant shares. The price is quoted as ex-dividend when there is not sufficient time between the delivery of the shares and closure of register of members or if such register has already been closed. In case of such a price, the buyer has not to pay anything for the dividend declared by the company on shares bought by him, since the seller will get the full dividend declared. The date for delivery of shares and payment of price is also fixed to a date after expiry of members' register closure period.

12.2.1 Accounting Treatment

The following points should be kept in mind while making accounting entries in respect of investments:

I. Interest: In respect of debentures and government securities, the price quoted is always to be taken as exclusive of interest. This means the buyer has to pay, besides the price for the securities, interest for the period for which the seller held the securities. In case the price has been given as cum-interest, the buyer shall not have to pay any amount by way of interest, since the price is inclusive of interest. In such a case the amount of cost of investment shall be the excess of money paid to the seller over any interest for the period for which the seller held such securities. The amount paid as interest should be shown in the interest column on the debit side of the investment account. On receipt of any interest, the amount should be credited to the investment account in the interest column.

At the end of the accounting year, a proper entry should be passed for the amount of interest accrued. This can be done by debiting the accrued interest account and crediting the investment account (in the interest column) with that amount of interest accrued. Next year, the entry should be reversed.

II. Dividends: In case the dividend has already been declared by the company and the shares have been purchased cum-dividend, the amount paid for dividends should be debited to the investment account in the dividend column. On receipt of dividend, the investment account should be credited in the dividend column. However, if the dividend has not yet been declared, the investment account should be debited with the full amount paid in the 'Principal' column. On receipt of dividend, the investment account should be credited in the 'Principal' column.

In case the shares have been purchased ex-dividend, the entire amount paid should be debited to the investment account in the 'Principal' column. In such a case, no dividend will be received by the buyer and, therefore, no entry for dividend will be required in the buyer's books on payment to the company.

III. Brokerage: Any amount paid by way of brokerage for purchasing securities should be taken as a part of the cost of securities and should be

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debited to the investment account in the 'Principal' column. Any brokerage paid on sale of securities should be deducted from the sale price of the securities and the investment account should be credited only with the net proceeds in the 'Principal' column.

IV. Bonus shares: Prosperous companies issue bonus shares from time to time to their equity shareholders. Since, the investor has not to pay any amount for such shares, entry should be made only in the 'Nominal value' column in the investment account on the debit side. Nothing is to be entered in the 'Principal' column.

V. Right shares: In case right shares are subscribed, their nominal value will be entered in the 'Nominal value' column and the amount paid in the 'Principal' column. Any amount received on account of renunciation of right in favour of a third party should be credited to the investment account in the 'Principal' column.

VI. Profit or loss on sale of securities: In case any securities are sold during the year, any profit or loss on sale of such securities is usually transferred to the profit and loss account. However, when securities are held as long-term investments, any profit on sale of such securities should preferably be transferred to the capital reserve in place of the profit and loss account.

VII. Valuation of securities: At the end of the accounting year, the securities are usually valued on the basis of "cost or market price whichever is less". Any loss on account of such valuation should be transferred to the profit and loss account. The balance in the interest column will also be transferred to the profit and loss account at the end of the accounting year.

Illustration 12.1: On 1st April, 2015, *XY* & Co. held 9% debentures in Banbury Ltd. of face value ₹ 10,000 at cost of ₹ 8,000. Market value on that date was ₹ 9,000. Interest is payable on 31st December every year. On 1st December, 2015 debentures of nominal value ₹ 6,000 were purchased for ₹ 5,000 ex-interest and on 31st December, 2015 debentures of nominal value ₹ 2,000 were sold cum-interest for ₹ 1,900. On 1st January, 2016 debentures of nominal value ₹ 6,000 were bought at ₹ 5,800. The market value of the debentures on 31st March, 2016 was ₹ 90.

Make out Investment Account in the books of *XY* & Co. showing profit or loss on sale of investment. Stocks on 31st March each year are valued at lower of cost and market price.

Solution

9% Debentures in Banbury Ltd.
(Interest payable on 31st Dec.)

Date	*Particulars*	*Nominal* ₹	*Interest* ₹	*Principal* ₹	*Date*	*Particulars*	*Nominal* ₹	*Interest* ₹	*Principal* ₹
2015					2015				
April 1	To Balance b/d	10,000	225*	8,000	Dec. 31	By Bank A/c			
Dec. 1	To Bank A/c	6,000	495	5,000		(FIFO basis)	2,000	180	1,720
Dec. 31	To Profit &				Dec. 31	By Bank A/c (Int.			
	Loss A/c					on 14,000 for			
	(Profit on sale					one year)		1,260	
	on FIFO Basis)			120	Mar. 31	By Accrued			
						Int. A/c			
2016						(Int. on 20,000			
Jan. 1	To Bank A/c	6,000		5,800		for 3 months)		450	
Mar. 31	To Profit &					By Balance c/d			
	Loss A/c		1,170			(Market Value			
						₹ 18,000)	20,000		17,200
		22,000	1,890	18,920			22,000	1,890	18,920

Working Notes:

1. Interest is payable on 31st Dec. each year. Interest must have been credit in the previous year on ₹ 10,000 for three months @ 9%. It comes to ₹ 225.
2. Purchases on 1st Dec. is ex-interest. *XY* & Co. shall pay 11 months interest on ₹ 6,000 debentures purchased. It comes to ₹ 495.
3. Sales on 31st Dec. is cum-interest. Of the total purchase price received, ₹ 180 is interest on ₹ 2,000 (nominal value) debentures.
4. Accrued Interest on 31st March has been calculated on ₹ 20,000 debentures for three months. It comes to ₹ 450.

Illustration 12.2: On 1st April 2014, Hasan has 20,000 equity shares of Vayu Ltd., at a book value of ₹ 20 per share (face value of ₹ 10 each). He provides the following information:

(i) On 10th June 2014, he purchased another 5,000 shares in Vayu Ltd., @ ₹ 15 per share.

(ii) On 1st August 2014 Vayu Ltd., issued one bonus share for every five shares held by the shareholders.

(iii) On 31st August 2014, the directors of Vayu Ltd. announced a rights issue which entitle the shareholders to subscribe two shares for every six shares held @ of ₹ 15 per share. The shareholders can transfer their rights in full or in part.

Hasan sold 1/4th of his right shares holding to Harsh for a consideration of ₹ 3 per share and subscribed the rest on 31st of October 2014.

Prepare Investment A/c in the books of Hasan as on 31st October. 2014.

Solution

Investment Account in the books of Hasan
(Equity shares in Vayu Ltd.)

NOTES

Date	*Particulars*	*No. of Shares*	*Amount (₹)*	*Date*	*Particulars*	*No. of shares*	*Amount (₹)*
01.04.14	To Balance b/d	20,000	4,00,000	31.08.14	By Bank A/c (Sale of rights) (*WN* 3)	0	7,500
10.06.14	To Bank A/c	5,000	75,000				
01.08.14	To Bonus issue (*WN* 1)	5,000	0	31.10.14	By Balance c/d (Bal. fig.)	37,500	5,80,000
31.10.14	To Bank A/c (Right shares) (*WN* 4)	7,500	1,12,500				
		37,500	5,87,500			37,500	5,87,500

Working Notes:

(1) Bonus shares = 25,000/ 5 = 5,000 shares

(2) Right shares = $\frac{25,000 + 5,000}{6} \times 2$ = 10,000 shares

(3) Sale of rights = 10,000 shares × ¼ × ₹3 = ₹ 7,500

(4) Rights subscribed = $\frac{3}{4}$ ₹15 = ₹ 1,12,500

Illustration 12.3: On 1st April, 2015, Singh had 20,000 equity shares in *X* Ltd. Face value of the shares was ₹ 10 each but their book value was ₹ 16 per share.

On 1st June, 2015, Singh purchased 5,000 more equity shares from the Company at a premium of ₹ 4 per share.

On 30th June, 2015, the Directors of *X* Ltd. announced a bonus and rights issue. Bonus was declared at the rate of one equity share for every five shares held and these shares were received on 2nd August, 2015. The terms of the rights issue were:

(a) Rights shares to be issued to the existing holders on 10th August 2015.

(b) Rights issue would entitle the holders to subscribe to additional equity shares in the Company at the rate of the one share per every three held at ₹ 15 per share, the whole sum being payable by 30th September, 2015.

(c) Existing shareholders may, to the extent of their entitlement, either wholly or in part transfer their rights to outsiders.

(d) Singh exercised his option under the issue for 50% of his entitlements; the balance of rights he sold to Ananth for a consideration of ₹ 1.50 per share.

(e) Dividends for the year ended 31st March, 2015 at the rate of 15% were declared by the Company and received by Singh on 20th October, 2015.

(f) On 1st November, 2015, Singh sold 20,000 equity shares at a premium of ₹ 3 per share.

Show the Investment Account as it would appear in Singh's books as on 31.12.2015 and the value of shares held on that date.

Solution

NOTES

BOOKS OF SINGH

Investment Account—Equity Shares in X Ltd.*[1]

Date	*Particulars (No. of shares)*	*Income* ₹	*Principal* ₹	*Date*	*Particulars (No. of shares)*	*Income* ₹	*Principal* ₹
2015				2015			
April 1	To Balance b/d (20,000)		3,20,000	Sept. 30	By Bank A/c (sale of rights: 5,000 @ ₹ 1.50)		7,500
June 1	To Bank A/c (5,000)		70,000				
Aug. 2	To Bonus Issue (5,000)		—	Oct. 20	By Bank A/c (Dividend)	30,000	7,500
Sep. 30	To Bank A/c (Rights) (5,000)		75,000	Nov. 1	By Bank A/c (20,000)		2,60,000
Nov. 1	To Profit & Loss A/c (Profit on sale)		2,856	Dec. 31	By Balance c/d (15,000)		1,92,856
Dec. 31	To Balance c/d	30,000					
		30,000	4,67,856			30,000	4,67,856

Working Notes:

Cost of shares sold

Amount paid for 35,000 shares		₹
(₹ 3,20,000 + ₹ 70,000 + ₹ 75,000)		4,65,000
Less: Amount received for rights	7,500	
Dividend on shares purchased on June 1	7,500	15,000
Cost of 35,000 shares		4,50,000
Cost of 20,000 shares (on average basis)		2,57,144
Sale proceeds		2,60,000
Profit		2,856

12.3 TYPES OF SECURITIES: FIXED INCOME AND VARIABLE INCOME SECURITIES

According to the Securities Contracts Regulation Act 1956, securities include shares, scrips, stocks, bonds, debentures or other marketable like securities of any incorporated company or other body corporate, or government. Various types of securities are traded in the market. Broadly securities represent evidence to property right. Security provides a claim on an asset and any future cash flows the asset may generate. Commonly we think of securities as shares and bonds. Securities are classified on the basis of return and the source of issue. On the basis of income they may be classified as fixed or variable income securities. In the case of fixed income security, the income is fixed at the time of issue itself. Bonds, debentures and preference shares fall into this category. Sources of issue may be government, semi government and corporate. The incomes of the variable securities vary from year to year.

* It has been assumed that the accounting year of Singh ends on March 31.

Dividends of the equity shares of companies' can be cited as an example for this. Corporate generally raises funds through fixed and variable income securities like equity shares, preference shares and debentures.

NOTES

A fixed-interest security is a debt instrument such as a bond, debenture, or gilt-edged bond that investors use to loan money to a company in exchange for interest payments. A fixed-interest security pays a specified rate of interest that does not change over the life of the instrument. The face value is returned when the security matures.

12.4 ROYALTY ACCOUNTS

The term "*Royalty*" means a payment in the nature to rent made by one person (called Lessee or Tenant) to another person (called Lessor or Landlord) for using certain asset which belongs to the latter. In other words, it is a payment made for having privilege of using some right. This right may be any of the following types:

(i) Right to extract some minerals such as oil, coal or stone etc., from land;

(ii) Right to use certain patents for the manufacture of articles for sale;

(iii) Right to publish and sell books under a copyright.

The principal forms of royalties are therefore:

(i) Mining royalties;

(ii) Patent royalties;

(iii) Copyright royalties.

Mining and Patent royalties are payable on production, while Copyright royalties are payable on sales.

12.4.1 Important Terms

1. Minimum rent

It is also termed as "Dead Rent", "Fixed Rent", or "Rock rent". As the term suggests, minimum rent means the rent payable by the tenant to the landlord irrespective of the fact whether he has derived any benefit or not, out of the property let out to him by the landlord. In other words, it is a guaranteed amount which the tenant has to pay irrespective of the benefit on which the royalty is based. The amount is fixed to avoid financial hardship to the landlord in the waiting period which must necessarily lapse before the production or sales can begin on a commercial scale.

2. Shortworkings

It is the excess of minimum rent over the actual royalties earned by the landlord. For example, if the minimum rent is ₹ 10,000 p.a. and the royalty is

@ 50 p. per tonne, then 20,000 tonnes must be produced before the minimum rent is covered. In case the production happens to be only 15,000 tonnes, the shortworkings would amount to ₹ 2,500 (i.e., excess of ₹ 10,000 over ₹ 7,500).

3. Recoupment of shortworkings

NOTES

Usually in contracts where there is a provision for minimum rent, there is also a provision for recoupment of shortworkings. It means that shortworkings allowed by the tenant to the landlord will be recoverable by him from the landlord during such periods when the actual royalty is more than the minimum rent. In other words, recoupment of shortworkings is the right of getting back from the landlord excess payment made by the tenant in the earlier years.

The right of recoupment of shortworking may be either (a) fixed, or (b) of a floating type.

In case of a fixed right of recoupment of shortworkings, the right is available only for a fixed period. In case the tenant is not in a position to recoup the shortworkings during this period, the balance amount will be a loss to him which will be written off from the Profit and Loss Account. This right may be given by inserting the recoupment clause in any of the following ways:

(a) "The Lessee/Tenant has a right to recoup shortworkings (say) during the first four years of the lease." This means that if, during this period, the lessee/tenant is not in a position to recoup the shortworkings allowed to him, the amount not so recouped will be a definite loss to him. Moreover, after the expiry of the first four years of the lease agreement, he will have no right to recoup the shortworkings.

(b) "Each year's excess of minimum rent over actual royalty is recoverable during the next (say) two years following the shortworkings." This means that the shortworkings of each year, if not recovered, can be carried forward for the next two years and not more. For example, if there is a shortworking of ₹ 500 in the year 2016, this can be recouped in the years 2017 and 2018. If it is not possible to recoup the shortworkings by the end of 2018, on account of actual royalty being less than the minimum rent, the shortworkings not so recouped will be transferred to the Profit and Loss Account.

12.4.2 Types of Problems

On the basis of the above discussion, the accounting problems regarding royalty accounts can be classified into the following categories:

(i) Royalties without any minimum rent.

NOTES

(ii) Royalties with a minimum rent:

(a) With the lessee/tenant having the right to recoup the shortworkings:

(1) without any limitation of time,

(2) within a limited time.

The limitation of time may commence either from the date of the agreement or from the date of the shortworkings.

(b) Without the lessee having the right to recoup the shortworkings.

Example**:** *A* grants a mine on lease to *B* with effect from 1st January, 2014 at a royalty of 50 p. per tonne of the coal produced. The following is the quantum of output for each year:

2014	3,000 tonnes
2015	5,000 tonnes
2016	6,000 tonnes

(i) In case there is no clause regarding minimum rent in the contract of royalty, *A* will get a sum of ₹ 1,500; 2,500; and 3,000 as royalties for the years 2014, 2015, and 2016 respectively.

(ii) If, in the above case, the minimum rent is fixed at ₹ 2,500 per annum and the shortworking is recoverable throughout the period of lease, *A* will get in 2014 the minimum rent of ₹ 2,500 (since the actual royalty being ₹ 1,500 only, the shortworkings amount to ₹ 1,000). This amount will be recoverable by *B* whenever the actual royalty exceeds the amount of minimum rent. In this case, ₹ 500 will be recovered in the year 2016 and the balance will be carried forward for being recovered out of royalties of subsequent years.

(iii) If, in the above case, the minimum rent is ₹ 2,500 and each year's shortworking is recoverable during the next two years, the shortworkings of ₹ 1,000 will be recoverable in 2016 to the extent of ₹ 500 only. The balance of ₹ 500 representing shortworkings not recouped will be transferred to the Profit and Loss Account in 2016.

(iv) If, in the above case, the minimum rent is ₹ 2,500 without any right of recoupment of shortworkings to the lessee, the shortworkings of 2014 ₹ 1,000 will not be carried forward but will be transferred as a loss to the Profit and Loss Account of 2014.

12.4.3 Accounting Entries

The following are the accounting entries to be passed in the books of the Lessee (or the Tenant) and the Lessor (or the Landlord).

Books of the Lessee (or the Tenant)

NOTES

A. Entries without Minimum Rent Account

(i) *On Royalty becoming Due:*
Royalty Account (with actual amount due) *Dr.*
Shortworkings Account (with the excess of minimum rent over actual royalty) *Dr.*
To Landlord's Account (with the minimum rent)

(ii) *When Royalty is Paid:*
Landlord's Account *Dr.*
To Bank (with the minimum rent)

(iii) *For Transfer of Royalty:*
Production / P & L A/c *Dr.*
To Royalty Account (with the actual royalty)

(iv) *Recoupment of Shortworkings:* It should be noted that Shortworkings Account will be debited only in those cases where the minimum rent is more than the actual royalty. In case the actual royalty is more than the minimum rent, the excess of actual royalty over the minimum rent will be utilised for entries for the royalty due and recoupment of the shortworkings allowed earlier. The recoupment of shortworkings will be as follows:

(a) Royalty Account *Dr.*
To Landlord
(with the actual royalty due)

(b) Landlord *Dr.*
To Bank Account
To Shortworkings Account
(Shortworkings Account will be credited with the amount of shortworkings recouped. The balances will be paid through bank account.)

Alternatively, the following entries may be passed:

(a) Royalty Account *Dr.*
To Landlord
To Shortworkings Account
(Shortworkings Account will be credited with the amount of shortworkings recouped. The balance will be credited to the Landlord's Account)

(b) Landlord *Dr.*
To Bank
(For payment of actual royalty less the amount of shortworkings recouped)

(v) *For Shortworking Not Recouped:*
Profit and Loss Account *Dr.*
To Shortworkings Account
(with the amount of shortworkings not recouped)

B. Entries with Minimum Rent Account: The entries for royalty due and shortworkings allowed can also be passed through Minimum Rent Account. However, it may be noted that the Minimum Rent Account will be opened only in those years where the actual royalty is less than the minimum rent. In years where the actual royalty is more than the amount of minimum rent, the entries will be passed without Minimum Rent Account, as explained earlier.

NOTES

(i) *For Minimum Rent Due:*
Minimum Rent Account *Dr.*
To Landlord
(with the amount of minimum rent)

(ii) Royalty Account (with the actual royalty) *Dr.*
Shortworkings Account (with the excess of minimum rent over actual royalty) *Dr.*
To Minimum Rent Account (with the amount of minimum of rent)

(iii) The entries for payment of Minimum Rent/Royalty and for recoupment of shortworkings will be the same as explained in the preceding pages in method *A*.

Books of the Lessor (or the Landlord)

A. Entries without Minimum Rent Account

(i) *On Royalty, becoming Due:*
Tenant (with minimum rent) *Dr.*
To Royalty Account (with actual royalty)
To Shortworkings Account
(with excess of minimum rent over actual royalty)

(ii) *On Receiving Payment:*
Bank Account *Dr.*
To Tenant Account (with the amount of minimum rent recd.)

(iii) *On Transfer of Royalty Account*
Profit and Loss Account *Dr.*
To Royalty Account
(with the actual amount of royalty)

(iv) *Recoupment of Shortworkings:* It may be noted that the Shortworkings Account is created in the books of the Landlord only when the amount of Minimum Rent is more than the amount of minimum rent, the shortworkings earlier allowed to the landlord will be recouped by the lessee.

(a) *On Royalty becoming Due:*
Tenant Account *Dr.*
To Royalty Account

(b) *On getting payment and recoupment of shortworkings:*
Bank Account *Dr.*
Shortworkings Account *Dr.*
To Tenant Account

(v) *For Shortworkings not recouped:*
Shortworkings Account *Dr.*
To Profit and Loss Account
(with the amount of gain made on account of non-recoupment of shortworkings by the tenant)

B. Entries with Minimum Rent Account: The Minimum Rent Account is to be opened only in those cases where the actual royalty is less than the minimum rent. In those cases where the actual royalty is more than the minimum rent, the entries will be passed on the same pattern as has been done in Method A explained in the preceding pages.

(i) *On Minimum Rent becoming Due*
(a) Tenant Account *Dr.*
To Minimum Rent Account
(with the amount of minimum rent)

(b) Minimum Rent Account *Dr.*
To Royalty Account (with the actual royalty)
To Shortworkings Account (with the excess of minimum rent over actual royalty)

(ii) The entries for receiving payment and recoupment of shortworkings and transfer of Royalty
Account will be the same as explained in method *A* earlier.

NOTES

Illustration 12.4: *B* wrote a book on accountancy and got it published from *A* on the terms that royalties will be 15% on the published price of the copies sold with a minimum of ₹ 10,000 per year. *B* gave an undertaking to revise the book when requested by the publisher and to pay ₹ 500 per month for every month of delay to *A* after six months of the request made by *A*. In the event of delay, the condition of the minimum amount ₹ 10,000 payable to *B* was not applicable. This arrangement was to last for 10 years, in the first instance. The number of copies sold and published price were as follows:

Year	*No. of copies sold*	*Published price (₹)*
2013	2,000	20
2014	4,000	20
2015	5,000	25
2016	2,000	25
2017	6,000	30

At the end of 2015, *B* was requested to revise the book. The revised manuscript reached *A* only on 1st November 2016.

You are required to pass necessary Journal entries and prepare Ledger accounts in the books of both *A* and *B*.

Solution

A's Journal

Date	*Particulars*	₹	₹
2013	Royalties A/c *Dr.*	6,000	
	Shortworkings Account *Dr.*	4,000	
	To *B*		10,000
	(*Being royalty @ 15% on ₹ 40,000 due subject to a minimum of ₹ 10,000*)		
2013	*B* *Dr.*	10,000	
	To Bank		10,000
	(Being payment made to B)		
2013	Profit and Loss Account *Dr.*	10,000	
	To Royalties Account		6,000
	To Shortworkings Account		4,000
	(Transfer of Royalties Account and Shortworkings Account to the Profit and Loss Account)		

NOTES

Date	Particulars		₹	₹
2014	Royalties Account	*Dr.*	12,000	
	To *B*			12,000
	(*Royalties @ 15% on ₹ 80,000*)			
	B	*Dr.*	12,000	
	To Bank Account			12,000
	(*Payment of the sum due*.)			
	Profit and Loss Account	*Dr.*	12,000	
	To Royalties Account			12,000
	(*Transfer of Royalties Account to the Profit and Loss Account*)			
2015	Royalties Account	*Dr.*	18,750	
	To *B*			18,750
	(*Being royalty @ 15% on ₹ 1,25,000*)			
	B	*Dr.*	18,750	
	To Bank Account			18,750
	(*Payment of the sum due*)			
	Profit and Loss Account	*Dr.*	18,750	
	To Royalties Account			18,750
	(*Transfer of Royalties Account to the Profit and Loss Account*)			
2016	Royalties Account	*Dr.*	7,500	
	To *B*			7,500
	(*The royalty @ 15% on ₹ 50,000; the condition of minimum amount does not apply this year as B delayed the revision work beyond 6 months of the request*)			
	B	*Dr.*	7,500	
	To Damages Recovered Account			2,000
	To Bank Account			5,500
	(*Payment of the sum due ₹ 2,000, being compensation for delay by B transferred to Damages Recovered Account*)			
	Profit and Loss Account	*Dr.*	7,500	
	To Royalties Account			7,500
	(*Transfer of Royalties Account to the Profit and Loss Account*)			
	Damages Recovered Account	*Dr.*	2,000	
	To Profit and Loss Account			2,000
	(*Transfer of damages recovered from B to the P & L Account*)			
2017	Royalties Account	*Dr.*	27,000	
	To B			27,000
	(*Being royalty @ 15% on ₹ 1,80,000*)			
	B	*Dr.*	27,000	
	To Bank Account			27,000
	(*Payment of the sum due*)			
	Profit and Loss Account	*Dr.*	27,000	
	To Royalties Account			27,000
	(*Transfer of the Royalties Account to the Profit and Loss Account*)			

Note: Since the publisher does not have the right to recoup shortworkings, the shortworkings of each year have been transferred to Profit and Loss Account.

NOTES

A's LEDGER

Royalties Account

2013	To *B*	6,000	2013	By P & L A/c	6,000
2014	To *B*	12,000	2014	By P & L A/c	12,000
2015	To *B*	18,750	2015	By P & L A/c	18,750
2016	To *B*	7,500	2016	By P & L A/c	7,500
2017	To *B*	27,000	2017	By P & L A/c	27,000

B's Account

2013	To Bank	10,000	2013	By Royalties A/c	6,000
				By Shortworkings A/c	4,000
		10,000			10,000
2014	To Bank	12,000	2014	By Royalties A/c	12,000
2015	To Bank	18,750	2015	By Royalties A/c	18,750
2016	To Damages recovered	2,000	2016	By Royalties A/c	7,500
	To Bank A/c	5,500			
		7,500			7,500
2017	To Bank A/c	27,000	2017	By Royalties A/c	27,000

Shortworkings Account

2013	To *B*	4,000	2013	By P & L A/c	4,000

Damages Recovered Account

2016	To P & L A/c	2,000	2016	By *B*	2,000

B's Journal

	Particulars		₹	₹
2013	*A*	*Dr.*	10,000	
	To Royalties Account			10,000
	(*Being royalties @, 15% on ₹ 40,000 subject to a minimum of ₹ 10,000*)			
2013	Bank Account	*Dr.*	10,000	
	To *A*			10,000
	(*Receipt of the sum due*)			
2013	Royalties Account	*Dr.*	10,000	
	To Profit and Loss Account			10,000
	(*Transfer of Royalties Account to the Profit and Loss Account*)			
2014	*A*	*Dr.*	12,000	
	To Royalties Account			12,000
	(*Being Royalties @ 15% on ₹ 80,000*)			
2014	Bank Account	*Dr.*	12,000	
	To *A*			12,000
	(*Receipt of the sum due*)			
	Royalties Account	*Dr.*	12,000	
	To Profit and Loss Account			12,000
	(*Transfer of Royalties Receivable Account to Profit and Loss Account*)			

NOTES

	Particulars		₹	₹
2015	*A*	*Dr.*	18,750	
	To Royalties Account			18,750
	(*Being royalties @ 15% on ₹ 1,25,000*)			
2015	Bank Account	*Dr.*	18,750	
	To *A*			18,750
	(*Receipt of the sum due*)			
2015	Royalties Account	*Dr.*	18,750	
	To Profit & Loss Account			18,750
	(*Transfer of Royalties Account to the Profit & Loss Account*)			
2016	*A*	*Dr.*	7,500	
	To Royalties Account			7,500
	(*Being royalties @ 15% on ₹ 50,000*)			
2016	Bank Account	*Dr.*	5,500	
	Damages Account	*Dr.*	2,000	
	To *A*			7,500
	(*Receipt of the sum due less ₹ 2,000 for delay in revising the book by 4 months*)			
2016	Royalties Account	*Dr.*	7,500	
	To Profit and Loss Account			7,500
	(*Transfer of Royalties Account to the Profit and Loss Account*)			
2016	Profit and Loss Account	*Dr.*	2,000	
	To Damages Account			2,000
	(*The Profit and Loss A/c debited by the damages paid*)			
2017	*A*	*Dr.*	27,000	
	To Royalties Account			27,000
	(*Being Royalties @ 15% on ₹ 1,80,000*)			
2017	Bank Account	*Dr.*	27,000	
	To A			27,000
	(*Receipt of the sum due*)			
2017	Royalties Account	*Dr.*	27,000	
	To P & L A/c			27,000
	(*Transfer of royalties receivable to P & L Account*)			

B's LEDGER
Royalties Account

	Particulars	₹	Particulars	₹
2013	To P & L A/c	10,000	By *A*	10,000
2014	To P & L A/c	12,000	By *A*	12,000
2015	To P & L A/c	18,750	By *A*	18,750
2016	To P & L A/c	7,500	By *A*	7,500
2017	To P & L A/c	27,000	By *A*	27,000

A's Account

	Particulars	₹	Particulars	₹
2013	To Royalties A/c	10,000	By Bank A/c	10,000
2014	To Royalties A/c	12,000	By Bank A/c	12,000
2015	To Royalties A/c	18,750	By Bank A/c	18,750
2016	To Royalties A/c	7,500	By Bank A/c	5,500
			By Damages A/c	2,000
		7,500		7,500
2017	To Royalties A/c	27,000	By Bank A/c	27,000

Illustration 12.5: *X* Coal Ltd. has taken on lease coal field from *Y* on the following terms:

(i) Lease is for 99 years.

(ii) Lease rent is to be 50 paise per annum for every tonne of coal raised.

(iii) Minimum royalty per annum to be ₹ 30,000; the lessee has a right to recoup any shortworkings within a period of three years for which the excess payment was made.

(iv) In case the working of the mines was affected by any strike or riot and, if there were no raisings, the minimum rent payable would abate proportionately.

(v) The following were the raisings for the different years:

2012	20,000	tonnes
2013	35,000	tonnes
2014	30,000	tonnes
	(there was a strike for three months during which no coal was mined)	
2015	70,000	tonnes
2016	80,000	tonnes
2017	1,00,000	tonnes

You are required to show the royalty, shortworkings, and landlord's accounts in the Books of *X* Coal Ltd.

Solution

BOOKS OF X COAL LTD.
Statement of Royalty Payable

Year	*Royalty (₹)*	*Shortworkings (₹)*	*Shortworkings recouped (₹)*	*Shortworkings not recouped (₹)*
2012	10,000	20,000	–	–
2013	17,500	12,500	–	–
2014	15,000	7,500	–	–
2015	35,000	–	5,000	15,000
2016	40,000	–	10,000	2,500
2017	50,000	–	7,500	–

NOTES

Royalty Account

Date	Particulars	₹	Date	Particulars	₹
2012	To *Y*	10,000	2012	By Production A/c (transfer)	10,000
2013	To *Y*	17,500	2013	By Production A/c	17,500
2014	To *Y*	15,000	2014	By Production A/c	15,000
2015	To *Y*	35,000	2015	By Production A/c	35,500
2016	To *Y*	40,000	2016	By Production A/c	40,000
2017	To *Y*	50,000	2017	By Production A/c	50,000

Shortworkings Account

Date	Particulars	₹	Date	Particulars	₹
2012	To *Y*	20,000	2012	By Balance c/d	20,000
2013	To Balance b/d	20,000	2013	By Balance c/d	32,500
	To *Y*	12,500			
		32,500			32,500
2014	To Balance b/d	32,500	2014	By Balance c/d	40,000
	To *Y*	7,500			
		40,000			40,000
2015	To Balance b/d	40,000	2015	By *Y* (Part of Shortwork-ings in 2012 Recovered)	5,000
				By Profit and Loss A/c (Shortworking of 2012 not Recoverable)	15,000
				By Balance c/d	20,000
		40,000			40,000
2016	To Balance b/d	20,000	2016	By *Y*	10,000
				By Profit and Loss A/c (Shortworking of 2013 not Recoverable)	2,500
				By Balance c/d	7,500
		20,000			20,000
2017	To Balance b/d	7,500	2017	By *Y*	7,500

Y's Account

Date	Particulars	₹	Date	Particulars	₹
2012	To Bank	30,000	2012	By Royalty A/c	10,000
				By Shortworkings A/c	20,000
		30,000			30,000
2013	To Bank	30,000	2013	By Royalty A/c	17,500
				By Shortworkings A/c	12,500
		30,000			30,000
2014	To Bank	22,500	2014	By Royalty A/c	15,000
				By Shortworkings A/c	7,500
		22,500			22,500
2015	To Shortworkings A/c	5,000	2015	By Royalty A/c	35,000
	To Bank A/c	30,000			
		35,000			35,000

Date	Particulars	₹	Date	Particulars	₹
2016	To Shortworking A/c	10,000	2016	By Royalty A/c	40,000
	To Bank	30,000			
		40,000			40,000
2017	To Shortworkings A/c	7,500	2017	By Royalty A/c	50,000
	To Bank	42,500			
		50,000			50,000

NOTES

Illustration 12.6: Maniram Singh, who has patented a circular TV antenna, granted Sky Enterprise a licence for ten years to manufacture and sell the product on the following terms:

(1) Sky Enterprise was to pay Maniram a royalty of ₹ 10 for each antenna sold.

(2) The minimum royalty for each of the first three years covered by the licence was to be ₹ 50,000. After these years royalties were to be payable on the actual number of antennas sold.

(3) If royalties on antennas sold amounted to less than ₹ 50,000, Sky Enterprise was entitled to deduct the deficiencies from royalties in excess of the sum payable in respect of each of the first three years of the agreement.

The number of antennas sold in the first four years were as follows:

Year ended 31st March,	2014	4,300
	2015	4,900
	2016	5,450
	2017	5,250

You are required to prepare the following ledger accounts recording the above transactions in respect of royalties in the books of Sky Enterprise:

(a) Royalties account

(b) Shortworkings account

(c) The account of Maniram Singh.

Solution

Computation of Royalty Payable, Minimum Rent and Shortworking

Year	*No. of Items*	*Royalty Payable* ₹	*Minimum Rent* ₹	*Shortworkings* ₹	*Shortworkings Recoverable* ₹
31.3.2014	4,300	43,000	50,000	7,000	
31.3.2015	4,900	49,000	50,000	1,000	
31.3.2016	5,450	54,500	50,000		4,500
31.3.2017	5,250	52,500	50,000		
				8,000	4,500

Net amount not recoverable (8,000 – 4,500) = 3,500

NOTES

(a) **Royalties Account**

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To M. Singh	43,000	31.3.2014	By Manfacturing A/c	43,000
31.3.2015	To M. Singh	49,000	31.3.2015	By Manfacturing A/c	49,000
31.3.2016	To M. Singh	54,500	31.3.2016	By Manfacturing A/c	54,500
31.3.2017	To M. Singh	52,500	31.3.2017	By Manfacturing A/c	52,500

(b) **Shortworkings Account**

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To M. Singh	7,000	31.3.2014	By Balance c/d	7,000
01.4.2014	To Balance b/d	7,000	31.3.2015	By Balance c/d	8,000
31.3.2015	To M.Singh	1,000			
		8,000			8,000
01.4.2015	To Balance b/d	8,000	31.3.2016	By M. Singh	4,500
				By P & L A/c	3,500
		8,000			8,000

(c) **Maniram Singh**

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To Bank A/c	50,000	31.3.2014	By Royalties A/c	43,000
				By S. W. A/c	7,000
		50,000			50,000
31.3.2015	To Bank A/c	50,000	31.3.2015	By Royalties A/c	49,000
				By S. W. A/c	1,000
		50,000			50,000
31.3.2016	To S. W. A/c	4,500	31.3.2016	By Royalties A/c	54,500
	To Bank A/c	50,000			
		54,500			54,500
31.3.2017	To Bank A/c	52,500	31.3.2017	By Royalties A/c	52,500
		52,500			52,500

Check Your Progress

1. What are bonus shares?
2. What is royalty?
3. When is a minimum rent account opened?

12.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Prosperous companies issue bonus shares from time to time to their equity shareholder. Since, the investor has not o pay any amount for such shares, entry should be made only in the nominal value column in the investment account on the debit side.

2. The term royalty means a payment in the nature to rent made by one person to another person for using certain asset which belongs to the latter.
3. The minimum rent account is to be opened only in those cases where the actual royalty is less than he minimum rent.

NOTES

12.6 SUMMARY

- Interest on securities or dividend on shares for a particular period is payable only to those persons whose names appear in the company's records. Since shares, debentures, etc are generally freely transferable, the company closes the register of members of debenture holders for a certain period by giving a sufficient public notice to that effect.
- The term "*Royalty*" means a payment in the nature to rent made by one person (called Lessee or Tenant) to another person (called Lessor or Landlord) for using certain asset which belongs the latter. In other words, it is a payment made for having privilege of using some right.
- Minimum rent is also termed as "Dead Rent", "Fixed Rent", or "Rock rent". As the term suggests, minimum rent means the rent payable by the tenant to the landlord irrespective of the fact whether he has derived any benefit or not, out of the property let out to him by the landlord.
- Usually in contracts where there is a provision for minimum rent, there is also a provision for recoupment of shortworkings. It means that shortworkings allowed by the tenant to the landlord will be recoverable by him from the landlord during such periods when the actual royalty is more than the minimum rent. In other words, recoupment of shortworkings is the right of getting back from the landlord excess payment made by the tenant in the earlier years.

12.7 KEY WORDS

- **Minimum Rent:** The rent payable by the tenant to the landlord irrespective of the fact whether he has derived any benefit or not out of the property let out to him by the landlord. It is also termed as "Dead Rent", "Fixed Rent", or "Rock Rent."
- **Royalty:** A payment in the nature of rent made by lessee or tenant to another person called lessor or landlord for using certain asset which belongs to the latter.
- **Shortworkings:** It is the excess of minimum rent over the actual royalties earned by the landlord.
- **Sub-Lease:** The transfer by the lessee of whole or part of his rights available under a contract of lease to another person.

12.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. Differentiate between cum-interest and ex-interest, cum-dividend and ex-dividend.
2. What are fixed income and variable income securities?

Long Answer Questions

1. Analyse the points that should be kept in mind while making accounting entries in respect of investments.
2. Describe the important terms of royalty accounts.

12.9 FURTHER READING

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

Jain, S.P. and Narang, K.L. 2001. *Advanced Accountancy*. New Delhi: Kalyani Publishers.

Ahmed, N. 2008. *Financial Accounting*. New Delhi: Atlantic Publishers and Distributors Pvt. Ltd.

UNIT 13 DEPARTMENTAL AND BRANCH ACCOUNTS

NOTES

Structure

13.0 INTRODUCTION

Business never works in isolation, it is always connected with different type of products and services. Big businesses or specialized businesses have products made with the help of several other goods and services. For example, there can be a large textile business with trading in varied products like cotton, jute and woolen materials. The profits and losses, the working and the decisions regarding the particular department reflects on the overall business. In accounting, it is important and beneficial to have dedicated accounts for different departments to ensure proper monitoring on the basis of which crucial planning decisions can be undertaken. It is a very strategically advantageous form of accounting for the management in a company and a proper knowledge of its nuances will help the managers ensure that the departmental segments build a stronger whole for the company. In this unit, you will learn about the meaning, objectives and advantages of departmental accounts, the distinction between departmental and branch accounts, the accounting procedure including the allocation of expenses and income, interdepartmental transfers and the provision for unrealized profits.

In this unit, you will also learn about branch accounting.

In order to market its product over large territories and to have an effective and efficient retailing, a business is generally split into branches or departments. In case the various divisions of the business are located under the same roof, they are known as Departments. If the various divisions of the business are located in different places, either in the same town or in different towns, they are known as Branches.

A proper accounting system is to be adopted for recording business transactions in case of a business having different branches or departments. The accounting system, in case a business which has several branches, is being explained in this unit.

13.1 OBJECTIVES

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

- Appreciate the utility of preparing departmental accounts
- Explain the basis for departmentalisation of expenses
- Compute costs relating to different departments
- Make appropriate accounting adjustments for interdepartmental transfer of goods or services
- Differentiate between a branch and a department
- Describe the concepts of a dependent and an independent branch
- Make accounting entries under different systems of keeping branch records
- Identify the causes of difference between the balances in the Head Office Account and the Branch Account and reconcile them
- Appreciate the need for making appropriate incorporation entries

13.2 DEPARTMENTAL ACCOUNTS: AN OVERVIEW

A business may have a number of departments each dealing in a different type of goods. For example, one department may be dealing in medicines, the other may be dealing in textiles, some other may be dealing in provisions, etc. In order to ascertain the profit or loss made by each department, it will be advisable to prepare separately a Trading and Profit and Loss Account of each department at the end of the accounting year.

Objectives of Departmental Accounts

There are several objectives of maintaining departmental accounts:

- Checking interdepartmental performance
- Assistance to management in cost control
- Serving as information for policy formulation in future
- Being the ready source of detailed information of the company and its working
- Serving as the right data source for year on year or other comparisons
- Fulfilling the role of insight for the departmental control
- Assisting in the allocation of profit to the departments
- Helping in monitoring different departments

Advantages of Departmental Accounts

Preparation of Departmental Accounts is helpful to the business in the following respects:

(i) It enables the business to compare the performance of one department with that of another.

(ii) It helps the business in formulating proper policies relating to the expansion of the business. New profitable lines of production or trading can be taken up while the existing lines of production or trading which are giving a loss can be closed down.

(iii) It helps in appropriate rewarding or penalising the department employees on the basis of the results shown by them.

Distinction Between Branch and Department

Point of Distinction	*Branch Account*	*Department Account*
Place of Maintenance of Accounts	There is an option of maintaining accounts at the branch or the head office.	Here are accounts are maintained at only one place.
Allocation of common expenses	Expenses can be easily identified and allocated to specific branch	Expenses are assigned on an agreed equitable basis to different departments
Reconciliation of accounts	It is imperative to reconcile the branch and head office account at the end of accounting year	Not applicable here
Conversion of foreign currency	In case of foreign branch, it becomes important to convert foreign currency into the home currency	Not applicable here

NOTES

Control	It is not easy for the head office to be constantly in charge of every activity	The chief of the department can keep a watchful eye on each activity
Accounts	It is a condensation of accounts.	It is a segment of accounts

Check Your Progress

1. State any three objectives of maintaining departmental accounts.
2. How is the preparation of departmental accounts?

13.3 ACCOUNTING PROCEDURE

Let us analyse the different accounting procedures here.

13.3.1 Maintenance of Columnar Subsidiary Books

The preparation of departmental Trading and Profit and Loss Account requires maintenance of proper subsidiary books having appropriate columns for different departments. For example, if a business has three departments, *A*, *B* and *C*, the subsidiary books such as Purchases Book, Purchases Returns Book, Sales Book, Sales Returns Book, etc. should have separate column for each department. Cash Book may also have columns for recording cash sales of each department separately in case the volume of cash sales is quite large. The following is a specimen of a Purchases Book having columns for different departments:

Purchases Book

Date	*Particulars*	*L.F.*	*Deptt. A*	*Deptt. B*	*Deptt. C*	*Deptt. D*

The same pattern of rulings may be followed in case of other subsidiary books also.

13.3.2 Allocation/Apportionment of Expenses and Income

In order to ascertain the profit or loss made by each department, it is necessary that each department is charged with a proper share of the various business expenses. The following basis may be adopted for departmentalisation of such expenes:

(i) Expenses incurred specifically for a particular department should be directly charged to that department. For example, salaries payable to each of the departmental managers will be charged to the respective departments. Similarly, if there are separate electricity meters for each of the departments, the electricity should be charged to each of departments on the basis of the electricity bills received by each one of them.

(ii) Expenses which have been incurred for the business as a whole but capable of being apportioned over different departments on a suitable basis should be charged to the different departments on such basis. Of course, there are no hard and fast rules as regards the basis to be applied for apportionment of such expenses. However, the following basis for apportionment may be adopted:

(a) ***Departmental wages:*** Expenses which directly vary with the department wages can be apportioned on this basis. For example, premium for workmen's compensation, insurance, E.S.I, etc.

(b) ***Capital value of the assets:*** Expenses such as depreciation of buildings, plants and machinery, fire insurance premiums in respect of these assets, etc., may be apportioned on this basis.

(c) ***Floor area:*** Expenses such as lighting (unless metered separately), rent and rates, wages of night watchman, etc., may be apportioned on this basis.

(d) ***Number of workers employed:*** Expenses of workers' canteen; welfare personnel, time keeping departments, etc., may be apportioned on this basis.

(e) ***Production hours of direct labour:*** Works manager's remuneration, general overtime expenses, and cost of interdepartmental transport should be charged to the various departments in the ratio which the Departmental Direct Labour Hours bear to the Total Factory Direct Labour Hours.

(f) ***Technical estimate:*** Advice of the technical personnel may also be useful for the apportionment of certain expenses, e.g., cost of steam consumed by a particular department may be estimated on the basis of the engineer's estimate.

(iii) Expenses which cannot be allocated or apportioned over different departments in a reasonable manner should be charged to the total profit of all the departments taken together. For this purpose, the profit shown by different departments should be brought down in one account which will be termed as the General Profit and Loss Account. General Manager's salary, Directors' fees, Auditors' remuneration, Interest on Debentures, etc., are some of the expenses which fall in this category.

13.3.3 Types of Problems

The problems relating to departmental accounts can be put in the following categories:

1. Problems relating to Departmentalisation of Expenses
2. Problems relating to Computation of Departmental Costs

NOTES

3. Problems relating to Interdepartmental Transfers:
   (a) When such transfers are at cost
   (b) When such transfers are at a price higher than the cost.

Exhaustive illustrations have been given in the following pages in respect of each of these types of problems.

Departmentalisation of Expenses

Illustration 13.1: M/s Raju Auto Garage have three departments: viz. (i) Cars and Trucks; (ii) Two-wheelers, and (iii) Servicing. The former two sell spare parts and occupy a godwn and a showroom. The servicing department uses a garage and adjoining site.

The following particulars are extracted from the books of the business for the year ended 31st March, 2017, from which you are required to prepare:

(a) A Departmental Trading and Profit and Loss Account,
(b) A General Profit and Loss Account, and
(c) A Balance Sheet.

Stock 1.4.2016	₹
Cars and Trucks	1,00,000
Two-wheelers	27,500
Purchases:	
Cars and Trucks	3,50,000
Two-wheelers	1,10,000
Sales:	
Cars and Trucks	6,00,000
Two-wheelers	3,00,000
Servicing	1,00,000
Wages of Counter-salesmen:	
Cars and Trucks	30,000
Two-wheelers	12,000
Wages of garage labour	10,800
Office Salaries and Wages	12,000
Godown and Showroom Rent	24,000
Land and Garage Building	2,72,000
Office Expenses	36,000
Garage Equipment	1,00,000
Showroom Furniture and Fittings	70,000
Office Van	24,000
Sundry Debtors	12,000
Sundary Creditors	60,000
Bank Overdraft	17,200
Power and Lighting	36,000
Bank Interest	1,000
Cash in Hand	900
Drawings Account	12,000
Proprietor’s Capital Account	1,63,000

Following further information is available:

(i) Included in Land and Garage Building the cost of site used by the servicing department ₹ 2,00,000.

(ii) Closing stock on 31. 3. 2017 at the Departments:

	₹
Cars and Trucks	90,000
Two-wheelers	32,500

(iii) 50% of power and lighting is to be charged to Servicing Department, the balance equally to the other departments.

(iv) Rates for depreciation are:

Building 5%; Garage Equipment 15%; Showroom Furniture etc. 10%; Office Van 20%.

(v) Outstanding expenses were Interest 150; Office expenses 2,000.

(vi) Interest and all expenses relating to the office are to be considered common and charged to the General Profit and Loss A/c.

(vii) The departments using the showroom share the space and Furniture and fittings equally.

Solution

M/S. RAJU AUTO GARAGE

Departmental Trading & Profit and Loss Account

for the year ending March 31, 2017

Particulars	*Cars & Trucks* ₹	*Two Wheelers* ₹	*Servicing* ₹	Particulars	*Cars & Trucks* ₹	*Two Wheelers* ₹	*Servicing* ₹
To Opening stock	1,00,000	27,500	—	By Sales	6,00,000	3,00,000	1,00,000
To Purchases	3,50,000	1,10,000	—	By Closing Stock	90,000	32,500	—
To Wages	30,000	12,000	10,800				
To Gross Profit c/d	2,10,000	1,83,000	89,200				
	6,90,000	3,32,500	1,00,000		6,90,000	3,32,500	1,00,000
To Godown and Showroom Rent	12,000	12,000	—	By Gross Profit b/d	2,10,000	1,83,000	89,200
To Power and Lighting	9,000	9,000	18,000				
To Depreciation:							
Building			3,600				
Garage Equipment			15,000				
Furniture	3,500	3,500	—				
To Net Profit c/d	1,85,500	1,58,500	52,600				
	2,10,000	1,83,000	89,200		2,10,000	1,83,000	89,200

NOTES

General Profit and Loss Account

for the year ending 31st March, 2017

Particulars		₹	Particulars	₹
To Office Salaries and Wages		12,000	By Profit b/d	
To Office Expnses	36,000		Cars and Truck Deptt.	1,85,500
Add: Outstanding	2,000	38,000	Two Wheelers Deptt.	1,58,500
To Depreciation on Van		4,800	Servicing Deptt.	52,600
To Bank Interest	1,000			
Add: Outstanding	150	1,150		
To Net Profit		3,40,650		
		3,96,600		3,96,600

Balance Sheet

as at 31 st March, 2017

Liabilities		₹	Assets		₹
Bank Overdraft		17,200	*Current Assets*:		
Outstanding Expenses:			Cash-in-Hand		900
Interest	150		Sundry Debtors		12,000
Office Expenses	2,000	2,150	Stock in trade		
Sundry Creditors		60,000	Cars and Trucks	90,000	
Capital	1,63,000		Two-wheelers	32,500	1,22,500
Add: Net Profit	3,40,650		*Fixed Assets:*		
	5,03,650		Land		2,00,000
Less: Drawings	12,000	4,91,650	Garage Building	72,000	
			Less: Depreciation	3,600	68,400
			Garage Equiment	1,00,000	
			Less: Depreciation	15,000	85,000
			Show Room Furniture & Fittings		
				70,000	
			Less: Depreciation	7,000	63,000
			Office Van	24,000	
			Less: Depreciation	4,800	19,200
		5,71,000			5,71,000

13.3.4 Computation of Departmental Costs

Illustration 13.2: The following purchases were made by a business house having three departments:

$$\left.\begin{array}{ll}\text{Department } A & 1{,}000 \text{ units}\\ \text{Department } B & 2{,}000 \text{ units}\\ \text{Department } C & 2{,}400 \text{ units}\end{array}\right\} \quad \text{at a total cost of ₹ 1,00,000}$$

Stock on 1st January were:

Department *A* 120 units, Department *B* 80 units, and Department *C* 152 units.

The sales were:

Department *A*	1,020 units @ ₹ 20 each.
Department *B*	1,920 units @ ₹ 22.50 each.
Department *C*	2,496 units @ ₹ 25 each.

NOTES

The rate of gross profit is the same in each case. Prepare Departmental Trading Account.

Solution

In order to determine the rate of Gross Profit, it is assumed that all units purchased have been sold away.

		₹
Sales:	Deptt. *A* 1,000 units @ ₹ 20 each	20,000
	Deptt. *B* 2,000 units @ ₹ 22.50 each	45,000
	Deptt. *C* 2,400 units @ ₹ 25 each	60,000
	Total Sales	1,25,000
	Less: Cost of Purchases	1,00,000
	Gross Profit	25,000

$$\text{Gross Profit as a percentage} = \frac{25,000}{1,25,000} \times 100 = 20\% = 20\%$$

Cost Price of units purchased for each department can now be ascertained as follows:

	Selling Price		*Gross Profit*		*Cost*
Deptt. *A*	₹ 20		₹ 4.00		16
Deptt. *B*	₹ 22.50		₹ 4.50		18
Deptt. *C*	₹ 25		₹ 5.00		20
Units of Closing Stock	Opening Stock	+	Purchases	–	Sales
Deptt. *A*	₹ 120	+	1,000	–	1,020 = 100
Deptt. *B*	₹ 80	+	2,000	–	1,920 = 160
Deptt. *C*	₹ 152	+	2,400	–	2,496 = 56

Departmental Trading Account can now be prepared as follows:

Departmental Trading Account

Particulars	*Deptt. A*	*Deptt. B*	*Deptt. C*	Particulars	*Deptt. A*	*Deptt. B*	*Deptt. C*
To Opening Stock	1,920	1,440	3,040	By Sales	20,400	43,200	62,400
To Purchases	16,000	36,000	48,000	By Closing Stock	1,600	2,880	1,120
To Gross Profit	4,080	8,640	12,480				
	22,000	46,080	63,520		22,000	46,080	63,520

Illustration 13.3: Shri Gangaram sells two products manufactured in his own factory. The goods are made in two departments *A* and *B* for which separate sets of accounts are maintainged. Some of the manufactured goods of Department A are used as Raw Material by Department *B* and vice versa.

From the following particualrs, you are required to ascertain the total cost of goods manufactured in Departments *A* and *B*:

Particulars	*Deptt. A*	*Deptt B*
Total uints manufactured	10,00,000	5,00,000
Total cost of manufacture (excluding interdepartmental transfers) (₹)	10,000	5,000

Department *A* transferred 2,50,000 units to Department *B* and the latter transferred 1,00,000 units to the former.

Solution

Suppose *a* is the total cost of department *A* is and *b* is the total cost of department *B*.

$$
\begin{array}{lrcl}
 & a & = & ₹\ 10{,}000 + 1/5\ b \\
 & b & = & ₹\ 5{,}000 + 1/4\ a \\
\text{or} & a & = & ₹\ 10{,}000 + 1/5\ (5{,}000 + 1/4\ a) \\
 & a & = & ₹\ 10{,}000 + 1{,}000 + 1/20\ a \\
 & a & = & ₹\ 11{,}000 + 1/20\ a \\
\text{or} & 20a & = & ₹\ 2{,}20{,}000 + a \\
\text{or} & 19a & = & ₹\ 2{,}20{,}000 \ \text{ or } a = ₹\ 11{,}579 \\
\text{Now} & b & = & ₹\ 5{,}000 + 1/4\ a \\
 & & = & ₹\ 5{,}000 + 1/4 \times ₹\ 11{,}579 \\
 & & = & ₹\ 5{,}000 + 2{,}985 \text{ or } ₹\ 7{,}895.
\end{array}
$$

Total Cost of Goods Manufactured

Particulars	*Deptt. A* ₹	*Deptt B* ₹
Cost as determined above	11,579	7,895
Less: Transfer to other department (1/3 and 1/5)	2,895	1,579
	8,684	6,316

Check Your Progress

3. Give some examples of expenses which can be apportioned on the basis of floor area.
4. List the category of problems which arise relating to departmental accounts.

13.4 INTER-DEPARTMENTAL TRANSFERS AT COST OR SELLING PRICE

Transfers of goods or services may take place from one department to another. While preparing the Departmental Trading and Profit and Loss Account, the department receiving the goods or services should be debited with the value of the goods or services so supplied and the department providing such goods or services should be credited with the same amount.

The transfer of goods from one department to another is usually at cost. However, if such transfer is at a profit, the profit or loss of each department should be ascertained on the basis of the transfer price itself. However, if the goods transferred by one department to another at a profit, still remain unsold with the transferee department, an appropriate reserve for unrealised profit will have to be created by means of the following journal entry.

General Profit and Loss Account *Dr.*
To Stock Reserve

In case the transferee department also has some stock in the beginning of the accounting year, including some unrealised profit, against which stock reserve was created last year, such reserve will also be transferred to the General Profit and Loss Account by means of the following journal entry

Stock Reserve Account *Dr.*
To General Profit and Loss Account

Alternatively, a single journal entry may be passed for the unrealised profit on the basis of the difference between unrealised profit included in the opening and closing stocks. This will be clear with the help of the following illustration.

Illustration 13.4: Form the following Trial Balance, prepare Departmental 'Trading and Profit and Loss Account, for the year ending 31st March, 2017 and the Balance Sheet as at that date:

		₹ *(in '000)*
Stock, 1st April 2016	*A* Department	1,700
	B Department	1,450
Purchases	*A* Department	3,540
	B Department	3,020
Sales	*A* Department	6,080
	B Department	5,125
Wages	*A* Department	820
	B Department	270
Rent, Rates, Taxes and Insurnace		939
Sundry Expenses		360
Salaries		300
Lighting and Heating		210
Discount allowed		222
Discount received		65
Advertising		368
Carriage Inward		234
Furniture and Fittings		300
Machinery		2,100
Sundary Debtors		606
Sundary Creditors		1,860
Capital Account		4,766
Drawings		450
Cash at Bank		1,007

The following further information is available:

1. Internal transfer of goods from Department *A* to *B* ₹ 42,000.
2. The items Rent, Rates, Taxes and Insurance, Sundry Expenses, Lighting and Heating, Salaries and Carriage are to be apportioned 2/3rd to Department *A* and 1/3rd to Department *B*.

3. Advertising is to be apportioned equally.
4. Discounts allowed and received are to be apportioned on the basis of Departmental Sales and Purchases (excluding Transfers).
5. Depreciation at 10 per cent per annum on Furniture and Fittings and on Machinery is to be charged 3/4th to Department *A* and 1/4th to Department *B*.
6. Services rendered by Department *B* to Department *A* are included in its wages ₹ 50,000.
7. Stock on 31st March, 2017 in *A* Department was worth ₹ 16,74,000 and in *B* Department ₹ 12,05,000.

Solution

Departmental Trading & Profit and Loss Account

for the year ending 31st March, 2017

(₹ in '000)

Particulars	*Deptt. A* ₹	*Deptt. B* ₹	Particulars	*Deptt. A* ₹	*Deptt. B* ₹
To Opening Stock	1,700	1,450	By Sales	6,080	5,125
To Purchases	3,540	3,020	By Transfer	42	50
To Wages	820	270	By Closing Stock	1,674	1,205
To Transfer	50	42			
To Carriage Inward	156	78			
To Gross Profit c/d	1,530	1,520			
	7,796	6,380		7,796	6,380
To Salaries	200	100	By Gross Profit b/d	1,530	1,520
To Rent, Rates, Taxes			By Discount	35	30
& Insurance	626	313	By Net Loss	126	—
To Sundry Expenses	240	120			
To Lighting and Heating	140	70			
To Advertising	184	184			
To Depreciation on:					
Machinery	158	52			
Furniture	22	8			
To Discount	121	101			
To Net Profit	—	602			
	1,691	1,550		1,691	1,550

Balance Sheet

as on 31st March, 2017

(₹ in '000)

Particulars		₹	Assets		₹
Capital	4,766		Machinery	2,100	
Add: Profit	476		*Less:* Depreciation	210	1,890
	5,242		Furniture and Fittings	300	
Less: Drawings	450	4,792	*Less:* Depreciation	30	270

Sundry Creditors	1,860	Stock in trade	2,879
		Sundry Debtors	606
		Cash at Bank	1,007
	6,652		6,652

NOTES

Illustration 13.5: Department *A* sells goods to Department *B* at a profit of 20% on cost and to Department *C* at 15% profit on cost. Department *B* sells goods to *A* and *C* at a profit of 10% and 20% on sales respectively. Department *C* sells goods to *A* and *B* at 15% and 10% profit on cost respectively.

Departmental managers are entitled to 10% commission on net profit subject to unrealized profit on departmental sales being eliminated. Departmental profits after charging manager's commission, but before adjustment of unrealized profit are as under:

	₹
Department A	*36,000*
Department B	*27,000*
Department C	*18,000*

Stocks lying at different departments at the end of the year are as below:

	Department A ₹	*Department B* ₹	*Department C* ₹
Transfer from Department *A*	–	7,200	5,750
Transfer from Department *B*	19,000	–	15,000
Transfer from Department *C*	4,600	3,300	–

Find out correct departmental profits after charging manager's commission

(CA *IPCC, Nov., 2012*)

Solution

Computation of Correct Departmental Profit

	Department A ₹	*Department B* ₹	*Department C* ₹
Profit after charging Manager's commission but before adjustment for Unrealized Profit	36,000	27,000	18,000
Add back: Manager's Commission (1/9)	4,000	3,000	2,000
	40,000	30,000	20,000
Less: Unrealised Profits on Stock (*Working Note*)	(1,950)	(4,900)	(900)
Profits before Manager's Commission	38,050	25,100	19,100
Less: Commission for Department Manager @10%	(3,805)	(2,510)	(1,910)
Correct Profit after charging Manager's Commission	34,245	22,590	17,190

Working Note:

Particulars	*Department A* ₹	*Department B* ₹	*Department C* ₹	*Total* ₹
Unrealised Profit on transfer to:				
Department A	—	1,200 = 20/120 × 7,200	750 = 15/115 × 5,750	1,950
Department B	1,900 = 10% × 19,000		3,000 = 20% × 15,000	4,900
Department C	600 = 15/115 × 4,600	300 = 10/110 × 3,300	—	900

Illustration 13.6: Mega Ltd. has two departments, *A* and *B*. From the following particulars, prepare departmental Trading A/c and General Profit & Loss Account for the year ended 31st March, 2017.

Particulars	*(₹) Amount*	
	Department A	*Department B*
Opening Stock as on 01.04.2016 (at cost)	70,000	54,000
Purchases	3,92,000	2,98,000
Carriage Inward	6,000	9,000
Wages	54,000	36,000
Sales	5,72,000	4,60,000
Purchased Goods transferred		
By Department *B* to *A*	50,000	
By Department *A* to *B*		36,000
Finished Goods transferred		
By Department *B* to *A*	1,50,000	
By Department *A* to *B*		1,75,000
Return of Finished Goods		
By Department *B* to *A*	45,000	
By Department *A* to *B*		32,000
Closing Stock		
Purchased Goods	24,000	30,000
Finished Goods	1,02,000	62,000

Purchased goods have been transferred mutually at their respective departmental purchase cost and finished goods at departmental market price and that 30% of the closing finished stock with each department represents finished goods received from the other department.

Solution

Mega Ltd.
Departmental Trading Account
for the year ended 31st March, 2017

Particulars	*Department A* (₹)	*Department B* (₹)	Particulars	*Department A* (₹)	*Department B* (₹)
To Opening Stock	70,000	54,000	By Sales	5,72,000	4,60,000
To Purchase	3,92,000	2,98,000	By Transfer:		
To Carriage Inward	6,000	9,000	Purchased Goods	36,000	50,000
To Wages	54,000	36,000	Finished Goods	1,30,000	1,18,000

Particulars	*Department A* (₹)	*Department B* (₹)	Particulars	*Department A* (₹)	*Department B* (₹)
To Transfers:			By Closing Stock:		
Purchased	50,000	36,000	Purchased Goods	24,000	30,000
Goods	1,18,000	1,30,000	Finished Goods	1,02,000	62,000
Finished	1,74,000	1,57,000	(*WN* 1)		
Goods (*WN* 2)	8,64,000	7,20,000		8,64,000	7,20,000
To Gross Profit c/d					

Working Notes:

1. *Finished goods from the other department included in closing stock:*

Particulars	*Department A* (₹)	*Department B* (₹)
Stock of Finished Goods	1,02,000	62,000
Stock related to the other department (30% of Finished Goods)	30,600	18,600

2. *Net transfer of finished goods by:*
   Department *A* to *B* = ₹ (1,75,000 – 45,000) = ₹ 1,30,000
   Department *B* to *A* = ₹ (1,50,000 – 32,000) = ₹ 1,18,000

Profit and Loss Account

For the year ended 31st March, 2017

Particulars	*Amount* (₹)	Particulars	*Amount* (₹)
To Provision for unrealised profit included in closing stock:		By Gross Profit b/d:	
		Department *A*	1,74,000
Department *A* (*WN* 4)	8,311	Department *B*	1,57,000
Department *B* (*WN* 4)	4,611		
To Net Profit	3,18,078		
	3,31,000		3,31,000

3. *Computation of ratio of gross profit margin on sales:*

Particulars	*Department A*	*Department B*
Sales	5,72,000	4,60,000
Add: Transfer of Finished Goods	1,75,000	1,50,000
	7,47,000	6,10,000
Less: Return of Finished Goods	(45,000)	(32,000)
	7,02,000	5,78,000
Gross Profit	1,74,000	1,57,000
Gross Profit margin =	$\frac{1,74,000}{7,02,000} \times 100 = 24.79\%$	$\frac{1,57,000}{5,78,000} \times 100 = 27.16\%$

4. *Unrealised profit included in the closing stock:*
   Department *A* = 27.16% of ₹ 30,600 (30% of Stock of Finished Goods ₹ 1,02, 000) = ₹ 8,311.
   Department *B* = 24.79% of ₹ 18,600 (30% of Stock of Finished Goods ₹ 62, 000) = ₹ 4,611.

NOTES

Illustration 13.7: Hotel High-brow prepares separate Departmental Profit and Loss Accounts. The nature of their operation required frequent supply of articles/services from one department to another. The Hotel consisted of three departments — Apartments, Boarding and Restaurant. It had been decided that the Apartments Department will charge for service supplied to other deparments the cost thereof plus 10% thereon. Likewise Boarding department was to charge the other departments cost plus 20% thereof in respect of supplies made to them. The Restaurant supplies to the other departments were charged at the prevailing rates applicable to outsiders. The accounts for the year ended on June 30, 2017 had been closed without taking into account the interdepartmental debits and credits. From the following figures, show the net variation in the departmental Profit and Loss Accounts as a result of such adjustments.

(1) Cost of Apartments services extended to:	₹
Boarding Staff	8,400
Restaurant Staff	4,500
(2) Cost of supplies made by Boarding Department to:	
Apartments Staff	29,800
Restaurant Staff	5,400
(3) Values of Supplies made by the Restaurant to:	
Apartments Staff	400
Boarding Staff	5,600

In addition, the following are the charges to be made for Interchange of staff from one department to another for temporary periods during the year:

Boarding staff lent to Apartments Deptt.
4,400
Apartments staff lent to Boarding Deptt.
1,100

Solution

Profit and Loss (Adjustment) Account

Particulars	*Apart-ment (A)* ₹	*Board-ing (B)* ₹	*Restau-rant (C)* ₹	Particulars	*Apart-ment (A)* ₹	*Board-ing (B)* ₹	*Restau-rant (C)* ₹
To Rent of				By Apartment Rents			
Apartments	—	9,240	4,950	from *B* 9,240			
To Boarding				*R* 4,950	14,190	—	—
Charges	35,760	—	6,480	By Boarding charges			
To Restaurant							
Expenses	400	5,600	—	from *A* 35,760			
To Charge in respect				*R* 6,480	—	42,240	—
of staff borrowed	4,400	1,100	—	By Restaurant			
To Increase in				Sales *A* 400			
deptt. profit				*B* 5,600	—	—	6,000

NOTES

(or decrease in deptt. loss)	—	30,700	—	By Recoveries in respect of staff rent	1,100	4,400	—
				By Decrease in deptt. profit (or increase in deptt. loss)	25,270	—	5,430
	40,560	46,640	11,430		40,560	46,640	11,430

Note: 10% has been added to costs of Apartments Deptt. Services to find out transfer price to Boarding and Restaurant. 20% has been added to costs of Boarding Department to find out transfer price of Apartments and Restaurant.

Check Your Progress

5. Which department is debited and credited in cases of inter-departmental transfers?
6. What is usually the basis of the transfer of goods from one department to another?

13.5 BRANCH ACCOUNTS: OBJECTIVES AND TYPES

We will discuss the features of these branch accounts are per their types in the succeeding sections.

In case of a company having different branches, a branch account is the account of the specific branch of a company having a location distant from the head office and in charge of activities like inventory keeping, sale and other procedures like recovery from the customers.

There are several objectives of branch accounting, some them include updated information on the cash position, inventory levels and profit gained and loss suffered by the branch; to stay on top of the performance of the staff at the specific branch and in conjunction disburse the commission accrued for the branch based on the sales and credit.

13.5.1 Types of Branches

Branches can be broadly classified into two categories for the purpose of recording transactions in the books of accounts:

(i) Dependent Branches;

(ii) Independent Branches:

(a) Home Branches;

(b) Foreign Branches

Another type of classification includes:

(i) Inland Branches

  (a) Independent Branch

  (b) Dependent Branch

(ii) Foreign Branches

In this unit, we will follow the first type of classification, i.e. dependent and independent branches.

13.5.2 Accounting for Branches Keeping Full System of Accounting

An important classification of branches for accounting is based on the manner in which accounts is being kept by the branches. Some branches keep full system of accounting and these are known as independent branches and the branches who are dependent on the head office for their accounts and do not maintain full system of accounting are known as dependent branches.

Check Your Progress

7. State the objectives of branch accounting.
8. Which type of branches do not maintain full system of accounting?

13.6 DEPENDENT BRANCHES

The term **Dependent Branch** means a branch which does not maintain its own set of books. All records have to be maintained by the Head Office. The following are the salient features of such a branch:

(i) The branch, does not maintain its own set of books. The Head Office maintains a record of all transactions. However, the branch maintains a Debtors' Ledger and a Stock Ledger. The Debtors' Ledger is maintained in order to find out the money due from debtors when the Branch is authorised to sell goods on credit. The Stock Ledger is kept to provide information regarding the movement of the goods received from Head Office and the balance of stock in hand.

(ii) Generally, all goods are supplied to the Branch by the Head Office. However, sometimes the branch may be allowed to make purchases from the local parties for which the payments are made directly by the Head Office.

(iii) Cash received by the Branch from its debtors or on account of cash sales is daily remitted to the Head Office. Usually, an account of the Head Office is opened in a local bank where all cash collections are deposited by the branch.

NOTES

(iv) All expenses of the Branch are directly paid by the Head Office through cheques. The Branch submits a summary to the Head Office for payments to be made by it during a particular period in respect of branch expenses.

(v) In order to meet the petty expenses of the branch, the branch may be provided with the petty cash from the Head Office. The branch keeps a record of the petty expenses in the Petty Cash Book, which is usually maintained on imprest system.

Systems of Accounting

In case of a dependent branch, the Head Office may keep accounts of the Branch according to any of the following systems:

(1) Debtors System

(2) Stock and Debtors System

(3) Final Accounts System

(4) Wholesale Branch System

Each of the aforementioned accounting systems have been explained in detail in the following pages:

13.6.1 Debtors System

This system is followed in case of branches of small size. The Head Office maintains a Branch Account, in its books. The Branch Account is of the nature of a nominal account. It is maintained on the following simple system:

(a) It is debited with whatever the Branch has in the beginning of the accounting year, e.g., the amount of stock, debtors, petty cash etc., *less* amount of any liability.

(b) It is debited with whatever has been sent by the Head Office to the Branch during the accounting year, e.g., the Head Office may send cash to the Branch for meeting its expenses or cash for certain purchases made by the Branch from outside parties.

(c) It is credited with whatever the Head Office receives from the Branch, e.g., cash remitted by branch on account of cash sales, collections from debtors, goods returned by the Branch etc.

(d) It is credited with whatever the Branch has at the end of the accounting period, e.g., the amount of stock, debtors, petty cash, any other asset etc.

The following accounting entries are passed in the books of the Head Office for recording different branch transactions.

(i) *For Goods Supplied by the Head Office* to *the Branch:*

Branch A/c *Dr.*

  To Goods sent to the Branch A/c

(ii) *For Goods Returned by the Branch to the Head Office:*
Goods sent to the Branch A/c *Dr.*
To Branch A/c

(iii) *For Goods sent by Branch to another Branch at instructions from Head Office:*
Goods sent to the Branch A/c *Dr.*
To Branch A/c
(treated at par with Goods Returned by Branch to Head Office)

(iv) *For Remittances Received from the Branch:*
Bank A/c *Dr.*
To Branch A/c

(v) *For Expenses at the Branch met by the Head Office:*
Branch A/c *Dr.*
To Bank A/c

(vi) *For Goods Returned by Branch Debtors to Head Office directly:*
Goods sent to the Branch A/c *Dr.*
To Branch A/c
(since this is as good as the Branch returning goods to the Head Office)

(vii) *For Transfer of Balance in Goods Sent to Branch Account:*
Goods Sent to the Branch A/c *Dr.*
To Purchases/Trading A/c

(viii) *For Assets at the Branch at the end of the Accounting Period:*
Branch Assets A/c *Dr.*
To Branch A/c
(debit each asset individually)

(ix) *For Liabilities at the end of the Accounting Period:*
Branch A/c *Dr.*
To Branch Liabilities A/c
(credit each liability individually)

(x) *For Profit or Loss:*
If Profit: Branch A/c *Dr.*
To General Profit and Loss A/c
If Loss: General Profit and Loss A/c *Dr.*
To Branch A/c

(xi) The assets and liabilities of the Branch at the end of the accounting year will appear in the Head Office Balance Sheet. In the beginning of the next year, they will be transferred to the Branch Account. The entry for such transfer will be as follows:
For transfer of Branch Assets:
Branch A/c *Dr.*
To Branch Assets A/c
(credit each asset individually)
For Branch Liabilities:
Branch Liabilities A/c *Dr.*
To Branch A/c
(debit each liability individually)
The Branch Account will appear as follows:

Branch Account

Particulars		₹	*Particulars*		₹
To Opening Balances*			By Opening Balances*		
Stock	...		Creditors	...	
Debtors	...		Outstanding Expenses	...	...
Petty Cash	...		By Bank		
Furniture	...		Cash Sales		...
Pre-paid Expenses	...	...	Collections from Debtors	...	...
To Goods sent to the			(for remittances)		
Branch A/c		...	By Goods sent to Branch A/c		...
To Bank (for expenses or any			(goods returned by the Branch		
payment made by the H.O. on			Branch Debtors directly to		
behalf of the Branch)			the Head Office or sent to other		
To Closing Balances*			branches)		
Outstanding Expenses	...		By Closing Balances*		
Creditors	...	...	Petty Cash	...	...
To Profit			Stock	...	
(Transferred to General			Debtors		
Profit and Loss Account**)		...	Furniture (at depreciated value)	...	
			Pre-paid Expenses	...	...
			By Loss		
			(Transferred to General		...
			Profit and Loss Account)**		
		...			...

* Alternatively the net amount may be shown.

** In case the credit side is more than the debit side, the Branch Account will show profit. If the debit side is more than the credit side, the Branch Account will show loss.

NOTES

Points Worth Noting

The following points should be kept in mind while recording transactions in the Branch Account:

I. ***Credit sales, shortage/surplus of stock, bad debts, discount, etc:*** No entry is made by the Head Office in the Branch Account in respect of the following:

(a) Credit sales made by the Branch.

(b) Shortage or surplus of stock at the Branch.

(c) Return of goods by the Branch Debtors to the Branch. Of course, if the Branch Debtors return the goods directly to the Head Office, they will be recorded by the Head Office on the same pattern as if the Branch has returned the goods to the Head Office.

(d) Discount, Bad Debts, etc.

II. ***Depreciation of fixed assets:*** Depreciation of Branch fixed assets is not shown in the Branch Account. However, the Branch Account is debited with the value of the fixed assets in the beginning of the accounting year and credited with the value of fixed assets at the end of the accounting year. The difference is the depreciation which is thus charged automatically. For example, if the branch has fixed assets worth ₹ 10,000 in the beginning of the accounting year and depreciation is to be charged at 10% p.a., the Branch Account will be debited with ₹ 10,000 in the beginning of the accounting year and credited by ₹ 9,000 at the end of the accounting year. Thus, depreciation of ₹ 1,000 has been charged automatically.

III. ***Petty expenses:*** No entry is made in respect of petty expenses incurred by the Branch out of its petty cash. The Branch Account is debited with opening balance of petty cash and amount sent by Head Office to the Branch for petty expenses. At the end of the accounting year, the Branch Account is credited with the closing balance of the petty cash. Thus, petty cash expenses are automatically charged to the Branch Account. This will be clear from the following example.

Petty cash balance in the Branch at the beginning of the accounting year ₹ 100

Cash sent by the Head Office to the Branch for meeting petty expenses ₹ 150

Petty expenses incurred by the Branch ₹ 200

In the above case the Branch Account will be debited with ₹ 250 (i.e., for opening petty cash balance and cash sent by the H.O.). It will be credited with ₹ 50 as petty cash balance at the end of the accounting year. Thus, it has been charged with ₹ 200 as petty cash expenses.

IV. ***Sale of fixed assets:*** The Branch may sell its fixed assets. Any amount realised on account of sale of fixed assets is remitted to the Head Office. In case, the fixed assets have been sold on credit, the amount due is shown as debtors at the Branch at the close of the accounting period. The assets at the end of the accounting period are shown at the net amount derived as follows:

Opening balance + Purchase of fixed assets – Amount realised on a ccount of sale of fixed assets.

No separate entry is made for the profit or loss made on the sale of fixed assets since it is automatically taken care of when both the opening and the closing balances and the amount realised on account of sale of fixed assets are recorded in the Branch Account.

V. ***Amount received from Insurance Company:*** In case insurance company admits a claim in respect of stock or any other property damaged at the branch, the amount received by the branch from the insurance company will be remitted to the Head Office. Thus, the amount of remittances from the Branch will increase. In case the claim admitted is outstanding till the date of the closing of the accounting period, the amount will be shown as an asset at the Branch on the credit side of the Branch Account.

Illustration 13.8: Gupta Brothers have their Head Office at Delhi and Branch at Kolkata. The following are the transactions of the Head Office with Branch for the year ended 31st August, 2016.

	₹	₹
Stock at Branch as on 1.9.2015		30,800
Debtors at the Branch as on 1.9.2015		16,500
Petty Cash as on 1.9.2015		500
Goods supplied to the Branch		1,51,200

Remittances from Branch:		
Cash Sales	10,500	
Realisation of Debtors	1,57,740	1,68,240
Amount sent to Branch:		
Salary	7,440	
Rent	2,400	
Petty Cash	3,000	12,840
Stock at Branch as on 31.8.2016		23,150
Sundry Debtors at the Branch as on 31.8.2016		50,460
Petty Cash as on 31.8.2016		750

Show the Branch Account in the books of the Head Office.

Solution

Gupta Brothers
Kolkata Branch Account

Date	*Particulars*		₹	*Date*	*Particulars*		₹
2015				2015			
Sep. 1	To Balance b/d:			Sep. 1	By Bank / Cash:		
	Stock at Branch		30,800		Cash Sales	10,500	
	Branch Debtors		16,500		Debtors	1,57,740	1,68,240
	Cash		500				
	To Goods Sent to			2016	By Balance c/d:		
	Branch A/c		1,51,200	Aug. 31	Stock at Branch		23,150
	To Bank: (Remittances)				Branch Debtors		50,460
	Salary	7,400			Cash at Branch		750
	Rent	2,400					
	Petty Cash	3,000	12,840				
	To Profit transferred						
	to Profit and Loss A/c		30,760				
			2,42,600				2,42,600

Pricing of Goods Sent to the Branch

The goods may be sent to the Branch by the Head Office either at cost price or at a price higher than cost price. In case goods are sent to the Branch at a price higher than cost price (generally termed as invoice price), adjustment entries are required to be made in the Branch Account for any profit included in the movement of goods from Head Office to the Branch or from Branch to the Head Office. This will be clear from the following example:

Example The Head Office sends goods to its Branch at cost plus 20%.

Goods costing ₹ 20,000 were sent by the Head Office to the Branch.

The Branch returned goods of the invoice value of ₹ 6,000

Closing stock at the Branch at invoice price ₹ 3,600

The following Journal entries will be passed in the books of the Head Office for the above transactions:

(i)	*For Goods Sent to the Branch (at invoice price):*			
	Branch Account	*Dr.*	24,000	
	To Goods Sent to the Branch Account			24,000
	(Cost ₹ 20,000 + 20% Profit)			
(ii)	*For Goods Returned by the Branch* (*at invoice price*):			
	Goods sent to the Branch Account	*Dr.*	6,000	
	To Branch Account			6,000
(iii)	*For Stock at the Branch* (*at invoice price*):			
	Stock at Branch Account	*Dr.*	3,600	
	To Branch Account			3,600
(iv)	*For adjustment of loading in Goods Sent to Branch Account:*			
	Goods Sent to the Branch Account	*Dr.*	3,000	
	To Branch Account			3,000
	(1/6th of ₹ 18,000 i.e., ₹ 24,000 – ₹ 6,000)			
(v)	*For adjustment of loading included in Closing Stock:*			
	Branch Account	*Dr.*	600	
	To Stock Reserve Account			600
	(1/6th of ₹ 3,600)			

The closing stock at the end of the year becomes the opening stock of the next year. Hence, it will be shown on the debit side of the Branch Account. The Stock Reserve created last year on the closing stock will be transferred to the Branch Account on the credit side next year. The following entries will be passed in the books of the Head Office for transfer of such Stock and Stock Reserve in the beginning of the next year:

(i)	*For recording Opening Stock:*	
	Branch Account	*Dr.*
	To Stock at Branch Account	
(ii)	*For recording of Stock Reserve on Opening Stock:*	
	Stock Reserve Account	*Dr.*
	To Branch Account	

Illustration 13.9: *X* & Co. of Delhi have a branch at Chennai. Goods are sent by the Head Office at invoice price which is at the profit of 25% on cost price. All expenses of the branch are paid by the Head Office. From the following particulars, prepare Branch Account in Head Office books: (a) when goods are shown at cost price and (b) when goods are shown at invoice price.

Opening Balance:	₹
Stock at invoice price	11,000
Debtors	1,700
Petty Cash	100
Goods sent to Branch at invoice price	20,000
Expenses made by Head Office:	
Rent	600
Wages	200
Salary	900
Remittances made to Head Office:	
Cash Sales	2,650
Cash collected from Debtors	21,000
Goods returned by Branch at invoice price	400

Balances at the end:

Stock at invoice price	13,000
Debtors at the end	2,000
Petty Cash	25

(*B.Com. (Pass) Delhi, adapted*)

NOTES

Solution

(a) **When goods are shown at cost price**

Chennai Branch Account

Particulars		₹	*Particulars*		₹
To Opening Balances:			By Cash:		
Stock (₹ 11,000 – 2,200)		8,800	Cash Sales	2,650	
Debtors		1,700	Cash Collected from Debtors	21,000	23,650
Petty Cash		100	By Goods Sent to Branch A/c		
To Goods Sent to Branch A/c		16,000	(Returned)		320
(at cost)			By Closing Balances:		
To Bank (Expenses):			Stock (at cost)		10,400
Rent	600		Debtors		2,000
Wages	200		Petty Cash		25
Salaries	900	1,700			
To Net Profit-transferred to					
General Profit and Loss A/c		8,905			
		36,395			36,395

(b) **When goods are shown at invoice price**

Chennai Branch Account

Particulars		₹	*Particulars*		₹
To Opening Balances:			By Cash:		
Stock		11,000	Cash Sales		2,650
Debtors		1,700	Cash collected from Debtors		21,000
Petty Cash		100	By Goods sent to Branch A/c		
To Goods sent to Branch A/c		20,000	(returned)		400
To Bank:			By Goods sent to Branch A/c		
Rent	600		(loading on net goods sent)		3,920
Wages	200		By Stock Reserve		
Salary	900	1,700	(loading in op. stock)		2,200
To Stock Reserve			By Closing Balances:		
(loading in closing stock)		2,600	Stock	13,000	
To Net Profit—transferred to			Debtors	2,000	
General Profit and Loss A/c		8,095	Petty Cash	25	15,025
		45,195			45,195

Ascertainment of Branch Stock and Branch Debtors

In case in an examination question, the balance (opening or closing) of the Branch Stock or Branch Debtors Account is not given, the students should prepare a Memorandum Branch Stock Account or a Memorandum Branch Debtors Account. The accounts will be prepared as follows:

NOTES

Memorandum Branch Stock Account

Particulars	₹	*Particulars*		₹
To Balance b/d	...	By Sales:		
To Goods Received from H.O.	...	Cash Sales	...	
To Goods Returned by Branch Debtors	...	Credit Sales	...	...
To Surplus of Stock	...	By Goods Returned to		
		Head Office		...
		By Shortage of Stock		...
		By Balance c/d		...
	...			...

It should be noted that the Branch Stock Account should be prepared either at cost or at invoice price. In case some of the items have been given at invoice price and the others at cost price, they should be suitably decreased or increased to bring all items to a uniform price. In case goods have been sent to the branch at invoice price, it will be better to prepare the Branch Stock Account at invoice price.

Memorandum Branch Debtors Account

Particulars	₹	*Particulars*	₹
To Balance b/d	...	By Cash Received	...
To Credit Sales	...	By Bills Receivable received	...
To Bills Receivable dishonoured	...	By Bad Debts	...
		By Discount	...
		By Sales Returns	...
		By Balance c/d	...
	...		...

The Memorandum Branch Debtors Account as shown above, is prepared on the same pattern on which a Total Debtors Account is prepared under Single Entry System.

Illustration 13.10: Vasan of Chennai has a branch at Kolkata. Goods are invoiced from the Head Office at cost plus 331/3%. Branch is allowed to make sales at invoice price only.

Expenses of the Branch except petty expenses are paid directly by the Head Office.

From the following particulars, you are required to prepare the necessary accounts to ascertain the net profit at the branch according to the Debtors System.

	₹
Debtors on 1.1.2016	10,000
Petty Cash on 1.1.2016 with the Branch	1,000
Stock on 1.1.2016 (at invoice price)	8,000
Goods invoiced by Head Office	88,000
Furniture on 1.1.2016	2,000

NOTES

Cash sent by Head Office for petty expenses at the Branch		2,000
Sales: Cash	50,000	
Credit	36,000	86,000
Sales Returns by Branch Debtors		800
Goods Damaged at Invoice Price		1,000
(amount recovered from the insurance company ₹ 500)		
Goods Returned by Branch to Head Office		2,000
Cash Remitted by Branch to Head Office		70,500
Branch Expenses:		
Freight and Cartage		500
Rent		1,000
Salary		3,900
Bad Debts		50
Depreciation on Furniture		80
Advertisement for the Branch		200
Petty Expenses		1,500

Solution

Branch Account

Particulars	₹	*Particulars*		₹
To Opening Balances:		By Remittances:		
Petty Cash	1,000	Cash Sales	50,000	
Debtors	10,000	Recovered from		
Stock	8,000	Insurance Co.	500	
Furniture	2,000	Collections from		
To Goods Sent to Branch A/c	88,000	Debtors	20,000	70,500
To Bank (expenses)	5,600	By Goods Sent to Branch		
To Bank (for petty expenses)	2,000	(returns)		2,000
To Stock Reserve (loading)	1,950	By Stock Reserve (loading)		2,000
To Net Profit	13,820	By Goods Sent to Branch		
		(loading)		21,500
		By Closing Balances:		
		Stock		7,800
		Debtors		25,150
		Petty Cash		1,500
		Furniture		1,920
	1,32,370			1,32,370

Goods Sent to Branch Account

Particulars	₹	*Particulars*	₹
To Branch Account (Returns)	2,000	By Branch Account	88,000
To Branch Account			
(loading on ₹ 86,000)	21,500		
To Trading Account			
(cost of goods sent to branch)	64,500		
	88,000		88,000

Working Notes:

(i) **Memorandum Branch Petty Cash Account**

Particulars	₹	*Particulars*	₹
To Balance b/d	1,000	By Petty Expenses	1,500
To Cash from Head Office	2,000	By Balance c/d	1,500
	3,000		3,000

(ii) **Memorandum Branch Stock Account**

Particulars	₹	*Particulars*		₹
To Balance b/d	8,000	By Sales:		
To Goods Sent to Branch	88,000	Cash	50,000	
To Branch Debtors A/c (Sales Returns)	800	Credit	36,000	86,000
		By Goods Returned by Branch		2,000
		By Goods Damaged		1,000
		By Balance c/d		7,800
	96,800			96,800

(iii) **Memorandum Branch Debtors Account**

Particulars	₹	*Particulars*	₹
To Balance b/d	10,000	By Branch Stock A/c (Sales Returns)	800
To Credit Sales	36,000	By Cash	20,000
		By Bad Debts	50
		By Balance c/d	25,150
	46,000		46,000

13.6.2 Stock and Debtors System

In case of this system, the Head Office maintains a number of accounts for keeping a record of Branch transactions in place of one branch account. A brief description of each of these accounts is given below:

I. ***Branch stock account:*** This account is on the pattern of a goods account. The account helps the Head Office in maintaining an effective control over the Branch Stock. It tells about shortage or surplus of stock and the closing stock at the Branch.

II. ***Branch debtors account:*** The account is maintained to keep a record of all transactions relating to Branch Debtors and ascertainment of the balance of the debtors at the end of the accounting period.

III. ***Branch fixed assets account:*** A separate account for each of the Branch Fixed Assets is maintained to record all transactions relating to each of these fixed assets.

IV. ***Branch cash account:*** The account is maintained to record all cash transactions of the Branch. This is particularly helpful in those cases where the Branch is not required to send immediately all collections of cash made by it but to remit money at regular intervals. The account helps the Head Office in having a control over Branch Cash.

V. ***Branch expenses account:*** The account is prepared to give to the Head Office a summary of different expenses, bad debts and discounts etc. incurred at the Branch.

VI. ***Branch adjustment account:*** The account is maintained for ascertaining the gross profit made at the Branch. All loadings in the goods sent to the branch, opening and closing stocks at the branch and shortage and surplus of stock etc. are recorded in this account.

VII. ***Branch profit and loss account:*** The account is prepared to ascertain profit or loss made at the Branch. The gross profit or loss from the Branch Adjustment Account is transferred to this account. It is debited with all other expenses and losses and credited with all gains and profits. The balance of the account represents the net profit or loss.

VIII. ***Goods sent to branch account:*** The account is prepared to ascertain the net value of goods sent to the Branch. Goods sent to the Branch and goods returned by the Branch and loading included in them are recorded in this account.

Journal Entries

The following journal entries are passed in the books of the Head Office in case the transactions are recorded according to the Stock and Debtors System:

(i) *For Goods Sent to the Branch* (at invoice price):
Branch Stock Account *Dr.*
To Goods sent to the Branch Account

(ii) *For Goods Returned by the Branch to the Head Office* (at invoice price):
Goods sent to the Branch Account *Dr.*
To Branch Stock Account

(iii) *For Credit Sales at the Branch* (at invoice price):
Branch Debtors Account *Dr.*
To Branch Stock Account

(iv) *For Cash Sales at the Branch* (at invoice price):
Cash Account *Dr.*
To Branch Stock Account

(v) *For Goods Returned by Branch Debtors to the Branch* (at invoice price):
Branch Stock Account *Dr.*
To Branch Debtors Account

(vi) *For Goods Returned by Branch Debtors Directly to the Head Office* (at invoice price):
Goods sent to the Branch Account *Dr.*
To Branch Debtors Account

(vii) *For Goods Sent by One Branch to another:*
It will be recorded as if the Branch has first returned the goods to the Head Office and then the Head Office has sent goods to another Branch. For example, if Branch *X* sends goods to Branch *Y,* the following entries will be passed:
(a) Goods sent to *X* Branch Account *Dr.*
To *X* Branch Stock Account
(b) *Y* Branch Stock Account
To Goods sent to *Y* Branch Account

(viii) *For Bad Debts, Discounts etc.:*
Branch Expenses Account *Dr.*
To Branch Debtors Account

(ix) *For Expenses at Branch:*
Branch Expenses Account *Dr.*
To Bank Account

(x) *For Abnormal Shortage (or Pilferage or Loss) of Stock:*
Branch Adjustment Account (with the amount of loading) *Dr.*
Branch Profit and Loss Account (with shortage at cost) *Dr.*
To Branch Stock Account (with the shortage at invoice price)
For surplus at Branch, a reverse entry will be passed.

No entry is required for normal loss of stock. The Branch Stock balance will be shown at the net amount as found by physical verification.

Any amount received from the Insurance Company for abnormal loss of stock (if insured), will be debited to Branch Cash Account and Credited to Profit and Loss Account.

(xi) *For transfer of Branch Expenses:*
Branch Profit and Loss Account *Dr.*
To Branch Expenses Account

(xii) *For adjustment of loading in the Opening Stock:*
Stock Reserve Account *Dr.*
To Branch Adjustment Account

(xiii) *For adjustment of loading in Closing Stock*:
Branch Adjustment Account
To Stock Reserve Account

(xiv) *For adjustment of loading in Net Goods sent to the Branch Account (i.e., goods sent less goods returned by branch):*
Goods sent to the Branch Account *Dr.*
To Branch Adjustment Account

(xv) *For transfer of the balance in Goods sent to the Branch Account:*
Goods sent to Branch Account *Dr.*
To Purchases/Trading Account

(xvi) *For transfer of Gross Profit shown by the Branch Adjustment Account:*
Branch Adjustment Account *Dr.*
To Branch Profit and Loss Account
In case of gross loss, the entry will be reversed.

(xvii) *For transfer of Net Profit at the Branch:*
Branch Profit and Loss Account *Dr.*
To General Profit and Loss Account
In case of net loss, the entry will be reversed.

Illustration 13.11: Vanni Music System invoices goods to its Faridabad branch at cost plus 20%. During the accounting year 2014–15, Vaani Music System invoiced goods amounting ₹ 15,000 were damaged in transit and insurance company admitted the claim ₹ 15,000. Show the treatment of loss in the books of Head Office under:

(i) Debtors System

(ii) Stock and Debtors System.

Solution

Books of Head Office
Journal of Faridabad Branch

(i) **Debtors System**

S. No.	Particulars		L.F.	Dr. (₹)	Cr. (₹)
1	Abnormal Loss A/c	Dr.		15,000	
	To Branch A/c				15,000
	(Being goods damaged in transit)				
2	Insurance claim A/c	Dr.		15,000	
	To Abnormal Loss A/c				15,000
	(Being claim received from Insurance company)				

(ii) **Stock & Debtors System**

S. No.	Particulars		L.F.	Dr. (₹)	Cr. (₹)
1	Abnormal Loss A/c	Dr.		15,000	
	To Branch Stock A/c				15,000
	(Being goods damaged in transit)				
2	Branch Adjustment A/c (₹ 15,000 × 1/6)	Dr.		2,500	
	Branch Profit & Loss A/c (Cost)	Dr.		12,500	
	To Abnormal Loss A/c				15,000
	(Being Abnormal Loss Adjusted)				
3	Insurance Claim A/c	Dr.		15,000	
	To Branch Profit & Loss A/c				15,000
	(Being claim received from Insurance company)				

Working Note:

Selling price (Invoice Price) = Cost + 20%   Let the Cost of good be ₹ 100

Then Selling Price, 100 + 20 = ₹ 120   20% Profit on Invoice Price = $\frac{20}{120} = \frac{1}{6}$

Independent Purchases by Branch

A branch may also be allowed to purchase goods from other parties besides getting goods from Head Office. In such a case, such goods will be appearing at cost and adjustment for loading will be required only in respect of goods received from Head Office at invoice or loaded price.

Illustration 13.12: The Head Office of a company invoices goods to its Shillong Branch at cost plus 20%. The Shillong Branch also purchases independently from local parties goods for which payments are made by the Head Office. All the cash collected by the Branch is banked on the same day to the credit of the Head Office. All expenses are directly paid by the Head Office except for a petty cash account maintained by the branch for which periodical transfers are made from the Head Office.

From the following particulars, show the Branch Account as maintained in the Head Office books, reflecting the Branch profit for the year ended 31st December, 2016.

	₹	₹
Imprest Cash:		
1.1.2016		2,000
31.12.2016		1,850
Sundry Debtors on 1.1.2016		25,000
Stock on 1.1.2016		
Transferred from H.O. at invoice price	24,000	
Directly purchased by Branch	16,000	40,000
Cash Sales		45,000
Credit Sales		1,30,000
Direct Purchases		45,000
Returns from Customers		3,000
Goods sent to Branch from H.O. at invoice price		60,000
Branch Expenses		30,000
Transfer from H.O. for petty cash expenses		2,500
Bad Debts		1,000
Discount to customers		2,000
Received from customers		1,25,000
Stock on 31.12.2016		
Transferred from H.O. at invoice value	18,000	
Directly purchased by Branch	12,000	30,000

Solution

Shillong Branch Account

Particulars		₹	*Particulars*		₹
To Balance b/d:			By Cash remitted:		
Cash	2,000		Cash Sales	45,000	
Debtors	25,000		Receipts from customers	1,25,000	1,70,000
Stock from H.O.	24,000		By Goods sent to Branch (loading)		10,000
Directly purchased	16,000	67,000	By Stock Reserve (opening balance)		4,000
To Cash (for purchases)	45,000		By Balance c/d:		
To Goods sent to Branch	60,000	1,05,000	Cash	1,850	
To Cash (for petty cash)		2,500	Debtors	24,000	
To Cash (expenses)		30,000	Stock:		
To Stock Reserve (on goods from H.O.)		3,000	From Head Office	18,000	
To Profit taken to P & L A/c		32,350	Purchased directly	12,000	55,850
		2,39,850			2,39,850

Note: The closing balance of debtors has been calculated as follows:

Particulars	₹	₹
Opening Balance	25,000	
Credit Sales	1,30,000	1,55,000
Less: Returns	3,000	
Bad Debts	1,000	
Discounts	2,000	
Cash Received	1,25,000	1,31,000
Closing Balance		24,000

NOTES

Sale of Goods by the Branch at a Price Higher or Lower than the Invoice Price

A branch may be allowed to sell goods at a price higher than the invoice price Since the Branch Stock Account is prepared at invoice price, in case of Stock and Debtors System, an adjustment entry will be required for the excess price charged by the Branch in order to ascertain the closing stock at the branch. The adjustment entry will be as follows:

Branch Stock Account *Dr.*
To Branch Adjustment Account
(with the amount of excess of selling price over the invoice price)

Similarly, if a branch is compelled to sell goods at a price lower than invoice price on account of goods being spoiled or their being of a defective nature, an adjustment entry on the above pattern will also be required. The entry will be as follows:

Branch Adjustment Account *Dr.*
To Branch Stock Account

Illustration 13.13: Dara Stores Ltd., with its head office at Delhi, invoiced goods to its branch at Ghaziabad at 20% less than the list price which is cost plus 100% with instructions that cash sales were to be made at invoice price and credit sales at catalogue price (i.e., list price).

From the following particulars available from the branch, prepare branch stock account, branch adjustment account, branch profit and loss account and branch debtors account for the year ending December 31, 2015. You are also required to verify the, gross profit so calculated by preparing branch trading account.

		₹
Stock on 1st January, 2015 (invoice price)		6,000
Debtors on January 1, 2015		5,000
Goods received from head office (invoice price)		66,000
Sales: Cash	23,000	
Credit	50,000	73,000
Cash received from debtors		42,817
Expenses at branch		8,683
Remittances to head office		60,000
Debtors on December 31, 2015		12,183
Stock at invoice price on December 31, 2015		8,800

Solution

If Cost Price is ₹ 100, List Price is Cost plus 100%, i.e., ₹ 200. Invoice Price is 20% less than list price, i.e., 200 – ₹ 40 = 160.

NOTES

Branch Stock Account

Particulars	₹	*Particulars*		₹
To Balance b/d (Invoice price)	6,000	By Cash Sales		23,000
To Goods sent to Branch A/c		By Branch Debtors (Credit Sales)		50,000
(at invoice price)	66,000	By Shortage (invoice price balancing fig.)		
To Branch Adjustment A/c		Charged to:		
(excess of list price over invoice		Branch Adj. A/c	75	
price in credit sales)	10,000	Branch P&L A/c	125	200
		By Balance c/d		8,800
	82,000			82,000

Branch Adjustment Account

Particulars	₹	*Particulars*	₹
To Branch Stock A/c: Shortage		By Branch Stock A/c	10,000
(₹ 200 × 60/160)	75	By Stock Reserve: Opening Stock	
To Stock Reserve: Closing Stock		(₹ 6,000 × 60/160)	2,250
(₹ 8,800 × 60/160)	3,300	By Goods sent to Branch A/c	
To Gross Profit transferred to		(₹ 66,000 × 60/160)	24,750
Branch Profit and Loss A/c	33,625		
	37,000		37,000

Branch Profit and Loss Account

Particulars	₹	*Particulars*	₹
To Branch Expenses A/c	8,683	By Gross Profit	33,625
To Branch Stock A/c (shortage at			
cost, i.e., ₹ 200 – ₹ 75)	125		
To Net Profit taken to General P & L A/c	24,817		
	33,625		33,625

Branch Debtors Account

Particulars	₹	*Particulars*	₹
To Balance b/d	5,000	By Cash	42,817
To Sales (credit)	50,000	By Balance c/d	12,183
	55,000		55,000

Goods Sent to Branch Account

Particulars	₹	Particulars	₹
To Branch Adjustment A/c	24,750	By Branch Stock A/c	66,000
To Purchases A/c	41,250		
	66,000		66,000

NOTES

13.6.3 Accounting Adjustments: Goods and Cash in Transit

In case of a dependent branch where the accounts are maintained according to Debtors System or Stock and Debtors System, the following adjustments may be required:

I. ***Goods in transit:*** It may be possible that some of the goods sent by the Head Office may not have been received by the Branch or some of the goods returned by the Branch may not have been received by the Head Office by the end of the accounting year. On account of these reasons, the amount of goods sent to the Branch as shown by the Head Office books may be different from the amount of goods received by the Branch as shown by the Branch returns.

The following adjustment entry will have to be passed for reconciling such difference in the Head Office books:

(a) *In case of Debtors System:*

Goods Sent to the Branch Account* *Dr.*
  To Branch Account
Or
Goods-in-transit Account *Dr.*
  To Branch Account

(b) *In case of Stock & Debtors System:*

Goods Sent to the Branch Account* *Dr.*
  To Branch Stock Account
Or
Goods-in-transit Account *Dr.*
  To Branch Stock Account

Note: The goods in transit should be added up with the closing stock figure of the Head Office for the purpose of Trading and Profit & Loss Account, in case this entry is passed instead of alternative entry.

II. ***Cash in transit:*** Cash may be sent from the Branch to the Head Office or from Head Office to the Branch. Such cash may not have been received by the Branch or the Head Office, as the case may be, by the end of the accounting year. The Head Office, should, therefore, pass the following adjustment entry for such cash in transit:

(a) *In case of Debtors System:*

Cash-in-transit Account *Dr.*
  To Branch Account

(b) *In case of Stock and Debtors System:*

Cash-in-transit Account *Dr.*
  To Branch Cash Account

NOTES

The Goods-in-transit and Cash-in-transit will appear as assets in the Balance Sheet of the Head Office.

Illustration 13.14: Rinco Ltd. has a branch at Lucknow. The branch does not maintain its own set of books. Goods of ₹ 40,000 were sent by the Head Office out of the which only goods of ₹ 36,000 have been received by the Branch. The Branch returns also show that a sum of ₹ 50,000 was remitted by it to the Head Office. The Head Office has received only a sum of ₹ 48,000. You are required to pass the necessary adjustment journal entries in case accounts are maintained by the Head Office according to:

(a) Debtors System;

(b) Stock and Debtors System.

Also state how the goods-in-transit should be dealt with in the Head Office books while preparing the Trading and Profit and Loss Account.

Solution

Books of Head Office
Journal Entries

(a) Debtors System

Date	*Particulars*		₹ *.Dr*	₹ *.Cr*
	Branch Account	*Dr.*	40,000	
	To Goods Sent to Branch Account			40,000
	(*Being Goods sent to Branch*)			
	Goods sent to Branch Account*	*Dr.*	4,000	
	To Branch Account			4,000
	(*Being goods-in-transit*)			
	Or			
	Goods-in-transit Account	*Dr.*	4,000	
	To Branch Account			4,000
	(*Being goods-in-transit*)			
	Bank Account	*Dr.*	48,000	
	To Branch Cash Account			48,000
	(*Being cash received from Branch*)			
	Cash-in-transit	*Dr.*	2,000	
	To Branch Account			2,000
	(*Being cash-in-transit*)			

(b) Stock and Debtors System

Date	*Particulars*		₹ *.Dr*	₹ *.Cr*
	Branch Stock Account	*Dr.*	40,000	
	To Goods sent to Branch			40,000
	(*Being goods sent to Branch*)			
	Goods sent to Branch A/c*	*Dr.*	4,000	
	To Branch Stock Account			4,000
	(*Being goods-in-transit*)			
	Or			
	Goods-in-transit A/c	*Dr.*	4,000	
	To Branch Stock Account			4,000
	(*Being goods-in-transit*)			

Date	Particulars	₹ .Dr	₹ .Cr
	Bank *Dr.* To Branch Cash Account (*Being cash remittance from Branch*)	48,000	 48,000
	Cash-in-transit *Dr.* To Branch Cash Account (*Being cash-in-transit*)	2,000	 2,000

NOTES

Note: Goods-in-transit should be added up with closing stock figure of Head Office for the purpose of Trading and Profit & Loss Account when this entry is passed instead of the alternative one.

13.6.4 Final Accounts System

The profit of a dependent branch can also be found out by the Head Office by preparing a Memorandum Branch Trading and Profit and Loss Account. The account is usually prepared at cost of goods sent to the Branch. In such cases, the Head Office may also maintain a Branch Account. The Branch Account so maintained is of the nature of a personal account as different from the Branch Account maintained by the Head Office in case of Debtors System which is of the nature of a nominal account. The balance in the Branch Account at the end of a particular period represents the net assets at the Branch (i.e., Assets–Liabilities at the Branch).

Illustration 13.15L M/s Ayaram Gayaram, Cuttack, started on 1st April, 2016, two branches at Behrampur and Nagpur. All goods sold at the branches are received from the head office invoiced at cost plus 25 per cent. All expenses relating to the branches are paid by the head office. Each branch has its own Sales Ledger and sends weekly statements.

All cash collections are remitted daily to the Head Office by the branches. The following particulars relating to the half year ended 30th September, 2016 have been extracted from the weekly statements sent by the Branches:

Particulars	*Behrampur* ₹	*Nagpur* ₹
Credit Sales	1,25,200	1,10,000
Cash Sales	78,600	82,200
Sales Returns	2,300	1,200
Sundry Debtors	34,500	23,600
Rent and Rates	3,200	4,500
Bad Debts	6,000	...
Salaries	16,000	18,000
General Expenses	2,600	1,500
Goods Received from H.O.	1,50,000	1,25,000
Advertisement	7,500	5,200
Stock on 30th September, 2016	45,000	35,000

You are required to prepare the Branch Accounts as they would appear in the books of the Head Office, showing the Profit or Loss for the period and the Trading and Profit and Loss Account separately for each branch.

(*C.A. Inter, adapted*)

Solution

Books of M/s Ayaram Gayaram, Cuttack
Branch Trading and Profit and Loss Accounts
(for the six months ended Sept. 30, 2016)

Particulars	*Behrampur* ₹	*Nagpur* ₹	*Particulars*	*Behrampur* ₹	*Nagpur* ₹
To Goods sent to Branch (Cost)	1,20,000	1,00,000	By Sales:		
			Credit	1,25,200	1,10,000
			Cash	78,600	85,200
To Salaries	16,000	18,000		2,03,800	1,95,200
To Rent and Rates	3,200	4,500	*Less:* Returns	2,300	1,200
To General Expenses	2,600	1,500		2,01,500	1,94,000
To Advertisement	7,500	5,200	By Closing Stock (Cost)	36,000	28,000
To Bad Debts	6,000	—			
To Net Profit to General Profit and Loss Account	82,200	92,800			
	2,37,500	2,22,000		2,37,500	2,22,000

Branch Accounts

Particulars	*Behrampur* ₹	*Nagpur* ₹	*Particulars*	*Behrampur* ₹	*Nagpur* ₹
To Goods Send to Branch Account	1,50,000	1,25,000	By Bank:		
To Bank:			Cash Sales	78,600	85,200
Salaries	16,000	18,000	Collection from debtors	82,400	85,200
General Expenses	2,600	1,500	By Goods Sent to Branch Account (Loading)	30,000	25,000
Rent and Rates	3,200	4,500			
Advertisement	7,500	5,200			
To Stock Reserve	9,000	7,000	By Balance c/d (Debtors & Stock)	79,500	58,600
To Profit and Loss Account (Profit)	82,200	92,800			
	2,70,500	2,54,000		2,70,500	2,54,000

13.6.5 Wholesale Branch System

Manufacturers may sell goods to the consumers either through the wholesalers and approved stockists or through their own branches. Selling goods to the consumers through manufacturers' own branches is helpful to the manufacturers in two different ways:

(i) It enables them to supply to the consumers goods of the right quality at the most reasonable price.

(ii) It also enables them to earn that profit also which the wholesalers would have earned by selling goods to the consumers through various retailers.

For example, if the cost price of an article to the manufacturer is ₹ 100, its wholesale price ₹ 125, retail price ₹ 160, and if the goods are sold to the consumers through wholesalers, the manufacturer will be in a position to earn only a profit of ₹ 25. The consumers get the article for ₹ 160 and the profit of ₹ 35 is taken by the wholesaler and the other middlemen. In case the manufacturer sells goods to the consumers through its own branch, it can earn the entire profit of ₹ 60. However, selling of goods through the Branch is profitable only when the Branch expenditure is not more than ₹ 35. In this case, since ₹ 25 the Head Office is otherwise earning. In case the expenditure of the Branch comes to ₹ 40, the net profit to the Head Office would not be more than ₹ 20. The Head Office, therefore, prepares the account of the branch on this basis that the invoice price (i.e., the wholesale price) is the cost price to the Branch instead of cost price to the Head Office being cost to the Branch, as has been done earlier. Thus, the profit of the Branch will be ascertained on invoice price basis. However, the Head Office will have to create a Stock Reserve for any unrealised profit in respect of goods (at invoice price) lying unsold at the Branch which are appearing there at invoice price. Such a system of finding out the profit or loss at the Branch is known as Wholesale Branch System. This will be clear with the help of the following illustration.

Illustration 13.16: The Mighty Bros. have their Head Office at Mumbai and a branch at Kanpur. The goods are sent to Branch at 20% less than the list price which is cost plus 100%.

From the following particulars, ascertain the profit made by the Branch as well as the Head Office on wholesale basis:

Particulars	*Head Office* ₹	*Branch* ₹
Opening Stock (cost/invoice price)	20,000	10,000
Purchases	2,00,000	
Expenses	30,000	6,000
Goods destroyed by accident at invoice price		1,000
Sales at list price	1,70,000	80,000
Goods sent to the Branch at invoice price	80,000	80,000

Solution

Branch Stock Account

Particulars	₹	*Particulars*	₹
To Balance b/d	10,000	By Cash/Drs. (Sales)	80,000
To Goods Sent to Branch Account	80,000	By P&L Account (Goods destroyed)	1,000
To Gross Profit c/d	16,000	By Balance c/d (*Note ii*)	25,000
	1,06,000		1,06,000

Branch Profit and Loss Account

Particulars	₹	*Particulars*	₹
To Goods destroyed	1,000	By Gross Profit b/d	16,000
To Branch Expenses	6,000		
To Net Profit	9,000		
	16,000		16,000

Goods Sent to Branch Account

Particulars	₹	*Particulars*	₹
To Trading Account	80,000	By Branch Stock Account	80,000
	80,000		80,000

General Trading and Profit and Loss Account (Head Office)

Particulars	₹	*Particulars*	₹
To Opening Stock	20,000	By Sales	1,70,000
To Purchases	2,00,000	By Goods sent to Branch	80,000
To Gross Profit c/d	1,15,000	By Closing Stock (*Note iii*)	85,000
	3,35,000		3,35,000
To Expenses	30,000	By Gross Profit b/d	1,15,000
To Stock Reserve [*Note (v)(b)*]	9,375	By Branch P & L A/c	9,000
To Net Profit taken to Balance Sheet	88,375	By Stock Reserve [*Note (v)(a)*]	3,750
	1,27,750		1,27,750

Working Notes:

(i) If Cost Price is ₹ 100
List Price will be ₹ 200.
Invoice Price will be ₹ 200 – 40 = ₹ 160

(ii) Closing Stock at Branch at Invoice Price
Closing Stock = Opening Stock + Goods from H.O. – Cost of Goods sold – Stock destroyed
= ₹ 10,000 + ₹ 80,000 – ₹ 64,000* – ₹ 1,000
= ₹ 25,000

$*80,000 \times \frac{160}{200}$

(iii) Closing Stock at Head Office at Cost
Closing Stock = Opening Stock + Purchases – Cost of Goods Sold – Cost of Goods sent to Branch
= ₹ 20,000 + ₹ 2,00,000 – ₹ 85,000* – ₹ 50,000**
= ₹ 85,000

$$*1,70,000\times\frac{100}{200}$$

$$**80,000\times\frac{100}{160}$$

(iv) Branch Stock Account prepared as above is similar to Branch Trading Account.

(v) Both Opening and Closing Stocks at the Branch are appearing at Invoice Price. The Head Office will have to make adjustments for unrealised profits included in opening and closing stocks at branch as shown below:

(a) Stock Reserve for Opening Stock at Branch:

$$10,000\times\frac{60}{160}=3,750$$

(b) Stock Reserve for Closing Stock at Branch:

$$25,000\times\frac{60}{160}=9,375$$

Check Your Progress

9. Why is a Stock Ledger kept?
10. What is a branch adjustment account?
11. State the adjustment entry to be passed by the Head Office for cash in transit in the stocks and debtors system.

13.7 INDEPENDENT BRANCHES

Independent Branch means a branch which maintains its own set of books. Such a branch can either be a Home Branch or a Foreign Branch. The method of accounting is the same in both the cases except that in case of a foreign branch, the trial balance sent by the foreign branch is to be converted into the currency of the country of the Head Office. Independent branches and their accounting is also known as accounting for branches keeping full system of accounting. In this unit, we will only discuss the accounting for home branch.

Home Branch

The characteristics of the accounting system of an independent Home Branch can be summarised as follows:

1. Such a Branch keeps a complete set of its books. Besides receiving goods from the Head Office, it may also purchase goods from outside parties. It means it maintains its own bank account. It may remit money from time to time to the Head Office as per the Head Office instructions.
2. It prepares its own Trial Balance and Final Accounts and sends their copies to the Head Office for their incorporation in the Head Office Books.
3. It maintains a Head Office Account in its books. This is of the nature of a personal account. All transactions relating to the Head Office are

recorded in this account. The Head Office also maintains a Branch Account in its books. It is also of the nature of a personal account. It records all transactions relating to the Branch in this account.

4. For inter-branch transactions, there are two alternatives available:
   (a) Each branch may open a separate account for each of the other branches. Such accounts are of the nature of personal accounts.
   (b) A branch may record transactions with the other branch on the same pattern as if the transactions are with the Head Office. In other words, all transactions relating to the other branches regarding receipts and sending of goods or cash are to be treated at par with the receipts of goods or cash from or to the Head Office. At the end of a period, the Branch sends a summary of the different transactions entered with different branches. The Head Office maintains account of each of the branches in which necessary adjustment entries may be passed and accounts of different branches reconciled.

   The latter method is generally followed by an independent Branch since it reduces a lot of clerical work at the Branch level.
5. On receipt of Trial Balance and Final Accounts from each of the Branches, the Head Office reconciles the Balance as shown in the Head Office Account in the Books of the Branch with the balance as shown by the Branch Account in the books of the Head Office. Necessary adjustment entries for reconciliation of difference are passed generally in the books of the Head Office.
6. Having reconciled the Branch balance, the Head Office passes the incorporation entries for incorporating various branch balances in its books.

Illustration 13.17: *A* has its Head Office at Mumbai and two branches at Delhi and Kanpur. Following are the inter-branch transactions during the month of January, 2015. You are required to pass the necessary journal entries in the books of the Head Office as well as the branches:

(1) Delhi Branch receives goods from Kanpur for ₹ 9,000
(2) Kanpur Branch receives goods from Delhi for ₹ 10,000
(3) Delhi Branch sends goods to Kanpur for ₹ 10,000
(4) Kanpur Branch receives cash from Delhi of ₹ 6,000
(5) Kanpur Branch sends goods to Delhi for ₹ 10,000
(6) Delhi Branch receives bills receivable from Kanpur for ₹ 5,000
(7) Kanpur Branch gets goods from Delhi Branch for ₹ 6,000

Solution

In case of frequent inter-branch transactions, each branch records transactions with the other branch as if they are with the Head Office and the Head Office passes periodical entries for such inter-branch transactions in its books.

The following table will be helpful for the necessary journal entries to be passed in the books of the Head Office as well as in the books of the Branch.

	Particulars	*Delhi*		*Kanpur*	
		Dr. ₹	*Cr.* ₹	*Dr.* ₹	*Cr.* ₹
1.	Delhi gets goods from Kanpur	9,000			9,000
2.	Kanpur gets goods from Delhi		10,000	10,000	
3.	Delhi sends goods to Kanpur		10,000	10,000	
4.	Kanpur gets cash from Delhi		6,000	6,000	
5.	Kanpur sends goods to Delhi	10,000			10,000
6.	Delhi receives bills receivable from Kanpur	5,000			5,000
7.	Kanpur gets goods from Delhi		6,000	6,000	
	Total	24,000	32,000	32,000	24,000
	Balance	8,000			8,000
		32,000	32,000	32,000	32,000

On the basis of the above table, the following journal entries will be passed in the books of the Head Office and the branches:

Books of Head Office

	Particulars		₹	₹
Jan. 31	Kanpur Branch Account	*Dr.*	8,000	
	To Delhi Branch Account			8,000

Books of Branches

The entries in the books of the branches regarding inter-branch transactions may be passed either immediately or at regular intervals on the basis of a memorandum record being kept. In case the entries are passed at the end of each month, the following entries will be passed in the books of the Branches on January 31.

Books of Delhi Branch

	Particulars		₹	₹
	Goods from Branches	*Dr.*	19,000	
	Bills Receivable Account	*Dr.*	5,000	
	To Head Office Account			24,000
	(*Being goods and B/R received from Kanpur Branch*)			
	Head Office Account	*Dr.*	32,000	
	To Goods Sent to Branches Account			26,000
	To Cash Account			6,000
	(*Being goods and cash sent to Kanpur Branch*)			

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Books of Kanpur Branch

	Particulars		₹	₹
	Goods from Branches Account	Dr.	26,000	
	Cash Account	Dr.	6,000	
	To Head Office Account			32,000
	(*Being goods and cash received from Delhi Branch*)			
	Head Office Account	Dr.	24,000	
	To Goods Sent to Branches Account			19,000
	To Bills Payable Account			5,000
	(*Being goods and acceptance sent to Delhi Branch*)			

Illustration 13.18: Head Office passes adjustment entry at the end of each month to adjust the position arising out of inter-branch transactions during the month. From the following inter-branch transactions in January, 2015, make the entry in the books of Head Office:

(a) Mumbai Branch
  (1) Received Goods: ₹ 6,000 from Kolkata Branch; ₹ 4,000 from Patna Branch.
  (2) Sent Goods: ₹ 10,000 to Patna; ₹ 8,000 to Kolkata.
  (3) Received B/R: ₹ 6,000 from Patna.
  (4) Sent Acceptance: ₹ 4,000 to Kolkata; ₹ 2,000 to Patna.
(b) Chennai Branch (apart from the above)
  (5) Received Goods: ₹ 10,000 from Kolkata; ₹ 4,000 from Mumbai.
  (6) Cash sent: ₹ 2,000 to Kolkata; ₹ 6,000 to Mumbai.
(c) Kolkata Branch (apart from the above).
  (7) Sent Goods to Patna: ₹ 6,000.
  (8) Paid B/P: ₹ 4,000 to Patna; ₹ 4,000 cash to Patna.

Solution

BOOKS OF HEAD OFFICE
Journal

Date	*Particulars*	₹ *.Dr*	₹ *.Cr*
2015			
Jan. 31	Chennai Branch A/c	6,000	
	Patna Branch A/c	16,000	
	To Mumbai Branch A/c		6,000
	To Kolkata Branch A/c		16,000
	(*Being adjustment entry passed by Head Office for inter-branch transactions during the month*)		

Working Note:

	Inter-branch transactions			
	Mumbai ₹	*Chennai* ₹	*Kolkata* ₹	*Patna* ₹
(a) Mumbai Branch				
(1) Receivable Goods	(*.Dr*)10,000		(*.Cr*)6,000	(*.Cr*)4,000
(2) Sent Goods	(*.Cr*)18,000		(*.Dr*)8,000	(*.Dr*)10,000
(3) Received B/R	(*.Dr*)6,000			(*.Cr*)6,000

	Inter-branch transactions			
	Mumbai ₹	Chennai ₹	Kolkata ₹	Patna ₹
(4) Sent Acceptance	(.*Cr*)6,000		(.*Dr*)4,000	(.*Dr*)2,000
(b) Chennai Branch				
(5) Received Goods	(.*Cr*)4,000	(.*Dr*)14,000	(.*Cr*)10,000	
(6) Cash Sent	(.*Dr*)6,000	(.*Cr*)8,000	(.*Dr*)2,000	
(c) Kolkata Branch				
(7) Sent Goods			(.*Cr*)6,000	(.*Dr*)6,000
(8) Paid B/P and Cash			(.*Cr*)8,000	(.*Dr*)8,000
	(.*Cr*)6,000	(.*Dr*)6,000	(.*Cr*)16,000	(.*Dr*)16,000

13.7.1 Reconciliation Entries: Goods and Cash in Transit

It has already been stated that the balance shown by the Branch Account in the Head Office books may not tally with the balance as shown by the Head Office Account in the Branch books. The reasons for the difference and accounting entries required are given below:

I. ***Goods-in-transit:*** The Head Office or the Branch may have sent goods to each other. These goods may not have been received by the end of the accounting year by the Head Office or the Branch as the case may be. The balance in the Head Office Account, therefore, will not tally with the balance in the Branch Account. The entry for reconciling the difference for this reason may either be passed in the Head Office books or the Branch Books *but not in both of them.*

In the Head Office Books:

Goods-in-transit Account *Dr.*
To Branch Account

In the branch Books:

Goods-in-transit Account *Dr.*
To Head Office Account

II. ***Cash-in-transit:*** The Head Office or the Branch may have sent cash to each other. The amount may not have been received by the Branch or the Head Office as the case may be, by the end of the accounting period. The entry for reconciliation of the difference on this account may either be passed by the Head Office or the Branch, *but not in both of them,* as follows:

In the Books of the Head Office:

Cash-in-transit Account *Dr.*
To Branch Account

In the Books of the Branch:

Cash-in-transit Account *Dr.*
To Head Office Account

Illustration 13.19: The following are the extracts from the Trial Balance of a Head Office and a Branch. You are required to pass the necessary Journal entries for reconciling the balances of the Head Office and the Branch.

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Trial Balance

Particulars	Head Office		Branch Office	
	₹ .Dr	₹ .Cr	₹ .Dr	₹ .Cr
Current Accounts	50,000			41,000
Goods sent to/received by Branch		75,000	70,000	

Solution

The current accounts disclose a difference of ₹ 9,000 between the two balances. Out of the difference of ₹ 9,000, ₹ 5,000 is on account of goods-in-transit. The balance of ₹ 4,000 may, therefore, be taken on account of cash-in-transit. The entry required for reconciling the current accounts may either be passed in the books of the Head Office or in the books of the Branch, but not in both of them.

In case entry is passed in the books of the Head Office:

Cash-in-Transit Account *Dr.* 4,000
Goods-in-Transit Account *Dr.* 5,000
To Branch Account
9,000

In case entry is passed in the books of the Branch:

Cash-in-Transit Account *Dr.* 4,000
Goods-in-Transit Account *Dr.* 5,000
To Head Office Account
9,000

13.7.2 Adjustment Entries

Besides the above reconciliation entries, adjustment entries may have to be passed at the end of the accounting year for certain transactions between the Head Office and the Branch. Such adjustment entries may relate to the following:

1. ***Depreciation on branch fixed assets' accounts maintained by the head office:*** Sometimes, the accounts of fixed assets at the branch are maintained by the Head Office. The following entries will, therefore, be required for depreciation on such fixed assets:

   In the Books of the Head Office
   Branch Account *Dr.*
   To Branch Fixed Assets Account
   In the Books of the Branch
   Depreciation Account *Dr.*
   To Head Office Account

2. ***Expenses incurred by the head office for the branch:*** The Head Office may like to charge the branch for the services rendered by it from time to time to the Branch. As a matter of fact, a part of the time of the Head Office employees may be taken only in doing the work for the Branch. For example, if the total amount

as salaries paid by the Head Office to its employees amounts to ₹ 20,000 and 1/4 of their time has been taken for the Branch work, 1/4 of the salaries, i.e., ₹ 5,000 should be charged to the Branch Account. The Head Office should, therefore, charge to its Profit and Loss Account only ₹ 15,000 on account of salaries of its employees. The necessary adjustment entry will, therefore, be passed as follows:

In the Books of the Head Office:

Branch Account *Dr.*
To Branch Expenses (Salaries) Account

In the Books of the Branch:

Head Office Expenses (or Expenses incurred by the Head Office) Account *Dr.*
To Head Office Account

Illustration 13.20: Show what entries would be passed by the Head Office to record the following transactions in their books:

(a) Goods amounting to ₹ 500 transferred from Coimbatore Branch to Rawalpindi Branch under instructions from Head Office.

(b) Depreciation of Branch Fixed Assets—Rawalpindi ₹ 2,000 and Coimbatore ₹ 3,000, when such accounts are opened in the Head Office Books.

(c) A remittance of ₹ 3,000 made by the Rawalpindi Branch to Head Office on 26th December, and received by the Head Office on 4th January.

(d) Goods of ₹ 5,000 sent by the Head Office to the Rawalpindi Branch on 20th December, and received by the latter on 15th January.

(e) A sum of ₹ 5,000 has to be charged to the Coimbatore Branch for Administrative services rendered by the Head Office.

Solution

Head Office Journal (Without Narratives)

	Particulars		*Dr.* ₹	*Cr.* ₹
(a)	Rawalpindi Branch Account	*Dr.*	500	
	To Coimbatore Branch Account			500
(b)	Rawalpindi Branch Account	*Dr.*	2,000	
	Coimbatore Branch Account	*Dr.*	3,000	
	To Rawalpindi Branch Fixed Assets Account			2,000
	To Coimbatore Branch Fixed Assets Account			3,000
(c)	Cash in Transit Account	*Dr.*	3,000	
	To Rawalpindi Branch Account			3,000
(d)	Goods-in-Transit Account	*Dr.*	5,000	
	To Rawalpindi Branch Account			5,000
(e)	Coimbatore Branch Account	*Dr.*	5,000	
	To Administrative Expenses Account			5,000

13.7.3 Incorporation of Branch Trial Balance in the Head Office Book

Since the consolidated Final Accounts of the Head Office and its Branches have to be prepared, it will be necessary for the Head Office to incorporate the Branch Balances in its books by means of suitable Journal entries. The incorporation of Branch Balances in the Head Office Books can be done by any of the following two methods:

(i) Detailed Incorporation;

(ii) Abridged Incorporation.

I. ***Detailed incorporation:*** In case of this method, all items relating to Trading and Profit and Loss Account are incorporated in the Head Office Books besides incorporation of Branch Assets and Liabilities. The Trading and Profit and Loss Account is prepared in the usual way in the books of the Head Office. The following entries are passed:

1. *For incorporating the items which are shown on the Debit side of the Trading Account:*
   Branch Trading Account *Dr.*
   To Branch Account
   (This entry is passed with the total amount of various items which are debited to the Trading Account such as Opening Stock, Purchases, Wages, Manufacturing Expenses etc.)
2. *For incorporating the items which are shown on the Credit side of the Trading Account:*
   Branch Account *Dr.*
   To Branch Trading Account
   (This entry is passed with the total of the different items which come on the credit side of the Trading Account, e.g., Sales, Closing Stock etc.)
3. *For transferring of Gross Profit to Branch P & L A/c:*
   Branch Trading Account *Dr.*
   To Branch P & L Account
   (In case of Gross Loss, the entry will be reversed)
4. *For incorporating the items appearing on the Debit side of the Branch P & L A/c:*
   Branch P & L A/c *Dr.*
   To Branch Account
   (This entry is passed with the total amount of the items which come on the Debit side of the P & L Account such as Salary, Rent, Commission, Depreciation, Discount, Bad Debts etc.)
5. *For incorporating the items which appear on the Credit side of the P & L Account:*
   Branch Account *Dr.*
   To Branch P & L Account
   (This entry is passed with the total amount of the items which come on the credit side of the P & L Account e.g., Interest received, Discount received, Commission earned.)

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6. *For transferring the Net Profit as shown by the Branch P & L A/c:*
   Branch P & L *A/c* *Dr.*
   To General or H.O. P & L Account
   (In case of Loss, the entry will be reversed)
7. *For incorporating of Branch Assets (after adjustments, if any):*
   Branch Assets Account *Dr.*
   (Each asset to be debited individually)
   To Branch Account
8. *For incorporating of Branch Liabilities (after adjustments, if any):*
   Branch Account *Dr.*
   To Branch Liabilities Account
   (Each liability to be credited individually)

As a result of these incorporation entries, the Branch Account in the Head Office Books will be completely closed.

In the beginning of the next year, the various assets and liabilities will be transferred back to the Branch by means of the following entries:

1. *For Transfer of Assets:*
   Branch Account *Dr.*
   To Branch Assets Account
   (*Credit each asset individually*)
2. *For Transfer of Liabilities:*
   Branch Liabilities Account *Dr.*
   (*Debit each liability individually*)
   To Branch Account

II. ***Abridged incorporation:*** In case of this method, the Branch Trading and Profit and Loss Account is prepared by the Head Office as a Memorandum Account only. The entries are passed only for incorporation of the Branch Net Profit or Net Loss and the Branch Assets and Liabilities. The following entries will be passed in the books of the Head Office in case this method is followed:

1. *For incorporating Branch Net Profit:*
   Branch Account *Dr.*
   To General Profit and Loss Account
   (In case of loss, the entry will be reversed)

It may be seen that this entry replaces first six entries which are passed in case of Detailed Incorporation Method.

2. *For incorporating Branch Assets:*
   Branch Assets Account *Dr.*
   (Debit each asset individually)
   To Branch Account
3. *For incorporating Branch Liabilities:*
   Branch Account *Dr.*
   To Branch Liabilities Account
   (Credit each liability individually)

It should be noted that in case entries are passed only for transfer of items relating to Trading and Profit and Loss Account or for incorporating only the Balance as shown by the Branch Profit and Loss A/c (and not for incorporation of Branch Assets and Liabilities), the Balance in the Branch Account at any time will show Net Assets at the Branch.

13.7.4 Entries in the Books of the Branch and Consolidated Balance Sheet

The Branch Books have also to be closed at the end of the accounting period. The entry for closing the books of the Branch may also be passed according to any of the two methods discussed in the preceding pages:

1. ***Detailed Incorporation Method*** According to this method, each item of Trading and Profit and Loss Account will be transferred to the Head Office Account besides each item of assets and liabilities. The following entries will be passed:

(i) *For transfer of items appearing on the Debit Side of the Trading and P & L Account:*

Head Office Account *Dr.*
  To Opening Stock
  To Purchases
  To Goods Received from the Head Office
  To Manufacturing Expenses
  To Rent
  To General Expenses etc.

(ii) *For transfer of items appearing on the Credit Side of the Trading and Profit and Loss Account:*

Sales Account *Dr.*
Closing Stock *Dr.*
Discount Received Account *Dr.*
Interest Received Account *Dr.*
  To Head Office Account

(iii) *For transfer of Branch Assets:*

Head Office Account *Dr.*
  To Branch Assets Account
(Each asset to be credited individually)

(iv) *For transfer of Branch Liabilities:*

Branch Liabilities Account *Dr.*
(Each liability to be debited individually)
  To Head Office Account

As a result of these entries, the Head Office Account in the books of the Branch will be completely closed.

2. ***Abridged Incorporation Method*** In case of this method, the Branch Trading and Profit and Loss Account will be prepared and the Net Profit (or Net Loss) as shown by the Branch Trading and Profit and

Loss Account will be transferred to the Head Office. The following journal entries will be passed in the books of the Branch:

In case of Profit:

P & L Account Dr.

To Head Office Account

In case of Loss, the entry will be reversed.

NOTES

The entries for transferring the Branch Assets and Branch Liabilities in the books of the branch will be the same as explained in the Detailed Incorporation Method.

Illustration 13.21: The Head Office of a business and its branch keep their own books and each prepares its own Profit & Loss Account. The following are the balances appearing in the two sets of the books as on 31st December, 2015 after ascertainment of profit and after making adjustments except those referred to below:

Particulars	*Head Office*		*Branch Office*	
	Dr. ₹	*Cr.* ₹	*Dr.* ₹	*Cr.* ₹
Capital	–	1,00,000	–	–
Fixed Assets	36,000	–	16,000	
Stock	34,200	–	10,740	–
Debtors and Creditors	7,820	3,960	4,840	1,920
Cash	10,740	–	1,420	–
Profit and Loss	–	14,660	–	3,060
Branch Office	29,860	–	–	–
Head Office Account	–	–	–	28,020
	1,18,620	1,18,620	33,000	33,000

Set out the Balance Sheet of the business as on 31st December, 2015 and the Journal entries necessary (in both sets of books) to record the adjustments dealing with the following:

(a) On 31st December, the branch had sent a cheque for ₹ 1,000 to the head office, not received by them nor credited to the branch till next month.

(b) Goods valued at ₹ 440 had been forwarded by the head office to the branch and invoiced on 30th December, but were not received by the branch nor dealt with in their books till next month.

(c) Stock stolen from the head office to the branch and charged to the branch by the head office but not credited to the head office in the branch books as the branch manager declined to admit any liability, ₹ 400 (not covered by insurance).

(d) It was agreed that the branch should be charged with ₹ 300 for administration services, rendered by the head office during the year.

(e) Depreciation of branch assets, of which accounts are maintained by the head office, not provided for ₹ 250.

(f) The balance of profit shown by the branch is to be transferred to the head office books.

Solution

Tutorial note: While attempting a question on an Independent Branch, you are advised to check whether the balance as shown by the Head Office Account in Branch books and the Branch Account in the Head Office books reconcile with each other or not. In the present question, there is a difference of ₹ 1,840. The difference is due to the causes (a), (b) and (d) as mentioned in the question.

The reconciliation entries will have to be passed for these causes. Moreover, adjustment entries will have to be passed for other adjustments and transfer of Branch profit.

Head Office Journal

	Particulars		*Dr.* ₹	*Cr.* ₹
	Cash-in-Transit Account	*Dr.*	1,000	
	To Branch Account			1,000
	(*For cash sent by Branch but not received by the Head Office till 31st December*)			
	Goods in Transit Account	*Dr.*	440	
	To Branch Account			440
	(*Goods invoiced on 30th December, not yet received by the Branch*)			
	Branch Account	*Dr.*	300	
	To P & L A/c			300
	(*For administrative services rendered by the Head Office to the Branch*)			
	Profit and Loss Account	*Dr.*	400	
	To Branch Account			400
	(*For uninsured stock stolen on way to Branch*)			
	Branch Account	*Dr.*	250	
	To Branch Assets Account			250
	(*For depreciation on branch assets, accounts for which are maintained by the Head Office*)			
	Branch Account	*Dr.*	2,510	
	To General Profit and Loss Account			2,510
	(*For profit shown by the Branch Profit and Loss Account transferred to General Profit and Loss A/c*)			

Branch Journal

	Particulars	*Dr.* ₹	*Cr.* ₹
	P & L Account *Dr.*	300	
	To Head Office Account		300
	(*For administrative services rendered by the Head Office*)		
	P & L Account *Dr.*	250	
	To Head Office Account		250
	(*For depreciation on branch assets, accounts for which are maintained by the Head Office*)		
	Profit and Loss Account *Dr.*	2,510	
	To Head Office Account		2,510
	(*For transfer of profit to General Profit & Loss Account*)		

Balance Sheet

as on 31st December, 2015

Liabilities		₹	*Assets*		₹
Capital:		1,00,000	Fixed Assets:		
Creditors:			Head Office		
			36,000		
Head Office	3,960		Branch 16,000	52,000	
Branch	1,920	5,880	*Less:* Depreciation	250	51,750
P & L Account:			Stock:		
Head Office	14,560		Head Office	34,200	
Branch	2,510	17,070	Branch	10,740	
			In Transit	440	45,380
			Debtors:		
			Head Office	7,820	
			Branch	4,840	12,660
			Cash:		
			Head Office	10,740	
			Branch	1,420	
			In Transit	1,000	13,160
		1,22,950			1,22,950

Working Notes:

1. The Profit at Branch and Head Office have been ascertained by preparing P & L Account of Head Office as well as Branch.

Branch P & L Account

Particulars	₹	*Particulars*	₹
To Head Office Expenses Account	300	By Profit (as given)	3,060
To Depreciation	250		
To Profit taken to General Profit and Loss Account	2,510		
	3,060		3,060

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General (H.O) P & L Account

Particulars	₹	*Particulars*	₹
To Branch Account (Stock stolen)	400	By Profit (as given)	14,660
To Profit c/d	14,560	By Branch Account	
		(Administrative services)	300
	14,960		14,960
To Balance of Profit taken to		By Profit b/d	14,560
Balance Sheet	17,070	By Branch Account	
		(Profit made by Branch)	2,510
	17,070		17,070

2. The Head Office Account in the books of the Branch and the Branch Account in the books of the Head Office will appear as follows:

(a) **Head Office Account**
(in the Books of the Branch)

Particulars	₹	*Particulars*	₹
To Balance c/d	31,080	By Balance b/d	28,020
		By Head Office Expenses Account	300
		By Depreciation	250
		By Profit and Loss Account	2,510
	31,080		31,080

(b) **Branch Account**
(in the Books of the Head Office)

Particulars	₹	*Particulars*	₹
To Balance b/d	29,860	By Goods-in-transit	440
To P & L Account	300	By Profit and Loss Account	400
To Branch Assets Account	250	By Cash-in-transit	1,000
To Gen. P & L Account	2,510	By Balance c/d	31,080
	32,920		32,920

(c) Balance in the Branch Account, represents the net assets at the Branch. This can be verified as follows:

	₹
Fixed Assets at Branch	16,000
Stock at Branch	10,740
Debtors at Branch	4,840
Cash at Branch	1,420
	33,000
Less: Creditors at Branch	1,920
	31,080

3. In the Consolidated Balance Sheet (of the Branch and the Head Office), the balance in the Branch Account in the books of the Head Office and the balance in the Head Office Account in the books of the Branch will not appear as, they are contrary to each other.

4. The fact mentioned in '3' above can also be verified by passing entries for incorporating Branch Assets and Liabilities in the Head Office books. Such entries will be as follows:

	Particulars		₹ *.Dr*	₹ *.Cr*
	Branch Fixed Assets	*Dr.*	16,000	
	Branch Stock	*Dr.*	10,740	
	Branch Debtors	*Dr.*	4,840	
	Branch Cash	*Dr.*	1,420	
	To Branch Account			33,000
	(*For incorporation of Branch Assets in the Head Office books*)			
	Branch Account	*Dr.*	1,920	
	To Branch Creditors Account			1,920
	(*For incorporation of Branch Liabilities*)			

As a result of the above incorporation entries, the Branch Account will be completely closed as shown below:

Branch Account
(in the Books of the Head Office)

Particulars	₹	*Particulars*	₹
To Balance b/d	31,080	By Branch Fixed Assets	16,000
To Branch Creditors	1,920	By Branch Stock	10,740
		By Branch Debtors	4,840
		By Branch Cash	1,420
	33,000		33,000

Pricing of Goods Sent to Branch at a Price Higher than the Cost

Goods may be sent to the Branch at a price higher than cost (or invoice price). In such a case, the profit at the Head Office and Branch can be ascertained according to any of the methods depending upon the prevalent practice in the organization.

1. Cost price to the Head Office may be taken as cost of the Branch. In such a case there can be two alternatives:
   (a) The Gross Profit of the Head Office as well as the Branch may be ascertained only after reducing the goods sent to Branch or received from Head Office to cost.
   (b) The Gross Profit at the Branch and Head Office may be calculated by taking goods sent to Branch or received from Head Office at Invoice Price to Branch. However, net profit at the Branch and Head Office is ascertained after making adjustments for loading included in Goods sent to Branch or Goods received from Head Office.

In both cases the amount of Net Profit will be the same.

2. The Profit of the Branch may be ascertained at Invoice price. In other words Invoice price to the Branch may be taken as cost price to the Branch. In such a case the Head Office will have to create a Stock Reserve for unrealised profit for unsold stock lying with the Branch. This is similar to finding out Profit in case of a wholesale branch, already explained in the preceding pages.

Illustration 13.22: Blue Ltd. has an issued share capital of ₹ 8,00,000 in shares of ₹ 10 each, fully paid. It has its head office in Mumbai and operates retail stores in Delhi and Chennai both of which commenced business on July 1, 2015.

All goods are purchased by the head office and invoiced to the branches at cost plus 20 per cent. The freehold buildings of the branches are recorded in the books of the head office, Delhi being debited with an annual rent of ₹ 5,000 and Chennai of ₹ 6,000. Subject to this, each branch keeps its own complete set of books. Goods are transferred from one branch to the other at head office invoice price. The following items, relating to the Profit and Loss Accounts, appear in the Trial Balance as on June 30, 2016.

Particulars	*Mumbai* ₹	*Delhi* ₹	*Chennai* ₹
Debits			
Purchase at Cost	9,56,300	—	—
Purchases at invoice price	—	6,21,900	5,37,900
Stock on July 1, 2015 at cost	1,06,400	—	—
Goods from other branches	—	14,300	25,700
Rent		5,000	6,000
Rates	3,600	4,900	5,300
General Expenses	17,800	29,000	29,600
Salaries & Wages	26,800	35,300	40,200
Bad Debts	—	6,700	4,200
Depreciation of Premises	13,000	—	—
Depreciation of Fittings	1,000	2,800	3,200
Interest	12,000	—	—
Credits			
Sales	—	6,76,300	6,14,600
Goods to other branches	—	26,600	14,900
Rent charged to branches	11,000	—	—
Goods invoiced to branches	11,64,000	—	—
P & L Account 1st July, 2015	34,950	—	—

Stock on hand on June 30, 2016 were, H.O., ₹ 92,700; Delhi, ₹ 40,800 (at invoice price) and Chennai, ₹ 31,500 (at invoice price).

Current accounts between the branches and the head office and between the branches agreed with one another with the exception of the following transactions which were not included in the stock of receiving branch or recorded in its books until July 2, 2016:

Goods invoiced from Mumbai to Delhi, ₹ 2,400 and to Chennai, ₹ 1,800.

Goods transferred from Delhi to Chennai ₹ 900 and from Chennai to Delhi, ₹ 600.

Provision is to be made in the head office for Directors' fees ₹ 20,000, auditors' remuneration, ₹ 5,250 and taxation on profits of ₹ 67,000. The Directors needed to set aside ₹ 25,000 to General Reserve, to recommend a dividend of 5 per cent and carry forward the balance of profit and loss account.

Ascertain the profit of the concern:

(i) When Gross Profit is to be ascertained by taking goods sent to the branch at cost.

(ii) When Gross Profit is to be ascertained by taking goods sent to the branch at invoice price but adjustment for loading is to be done in the Profit and Loss Account.

(iii) When Profit is to be ascertained by taking goods sent to the branch at invoice price.

Solution

Basic Calculations

Goods Sent to Branches

Particulars	*Invoice price*		*Cost price*	
	₹ Delhi	*₹ Chennai*	*₹ Delhi*	*₹ Chennai*
Goods received by Branches	6,21,900	5,37,900	5,18,250	4,48,250
Goods-in-transit	2,400	1,800	2,000	1,500
	6,24,300	5,39,700	5,20,250	4,49,750

Goods Received by Branches

Particulars	*Invoice price*		*Cost price*	
	₹ Delhi	*₹ Chennai*	*₹ Delhi*	*₹ Chennai*
Goods from Head Office	6,21,900	5,37,900	5,18,250	4,48,250
Less: Goods to other Branches	26,600	14,900	22,167	12,417
Add: Goods from other Branches	14,300	25,700	11,917	21,417
Total	6,09,600	5,48,700	5,08,000	4,57,250

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Closing Stock

Particulars	*Delhi*		*Chennai*	
	Invoice price	*Cost*	*Invoice price*	*Cost*
as on 30th June, 2016	40,800	34,000	31,500	26,250

(i) When Gross Profit is ascertained at cost

Profit and Loss Appropriation Account
(Year ended 30th June 2016)

Particulars	₹	*Particulars*		₹
To Provision for Taxation	67,000	By Balance b/d		34,950
To General Reserve (Transfer)	25,000	By Profit for the current year:		
To Proposed Dividend	40,000	Delhi Branch	1,18,600	
To Balance c/d	28,200	Chennai Branch	95,100	
			2,13,700	
		Less: Loss at Head office	88,450	1,25,250
	1,60,200			1,60,200

Note: It is not necessary to take in to account the items in transit for preparing Profit & Loss A/c.

(ii) When Gross Profit is ascertained at invoice price but adjustment for loading in Profit & Loss Account

The Profit & Loss Appropriation Account will be prepared as in case (i).

(iii) If profit is ascertained at invoice price

In such a case, the Gross Profit will be the same as shown under Method II. However, the amount of Net Profit of the Branches and that of the Head Office will be different but total Net Profit of the Business for the year will remain the same.

General Profit and Loss Account

Particulars	₹	*Particulars*	₹
To Stock Reserve (Closing Stock):		By Net Profit bid:	
Delhi	6,800	Delhi Branch	23,800
Chennai	5,250	Chennai Branch	8,900
In transit		Head Office	1,05,550
[(1/6 of (2,400 + 1,800 + 900 + 600)]	950		
To Net Profit c/d	1,25,250		
	1,38,250		1,38,250

Profit & Loss Appropriation Account

Particulars	₹	*Particulars*	₹
To Provision for Taxation	67,000	By Balance b/d	34,950
To General Reserve (Tr)	25,000	By General P & L Account	
To Proposed Dividend	40,000	(Net Profit b/d)	1,25,250
To Balance c/d (To b/s)	28,200		
	1,60,200		1,60,200

NOTES

Trading & Profit and Loss Account

for the year ending 30th June, 2016

Particulars	Mumbai ₹	Delhi ₹	Chennai ₹	Particulars	Mumbai ₹	Delhi ₹	Chennai ₹
To Opening Stock	1,06,400	–	–	By Sales	–	6,76,300	6,14,600
To Purchases	9,56,300	–	–	By Goods sent to Branches:			
To Goods from Head Office	–	5,18,250	4,48,250	Delhi	5,20,250	–	–
To Goods from other Branches	–	11,917	21,417	Chennai	4,49,750	–	–
To Gross Profit c/d	–	2,02,300	1,83,600	By Goods to other Branches	–	22,167	12,417
				By Closing Stock	92,700	34,000	26,250
	10,62,700	7,32,467	6,53,267		10,62,700	7,32,467	6,53,267
To Rent	–	5,000	6,000	By Gross Profit b/d	–	2,02,300	1,83,600
To Rates	3,600	4,900	5,300	By Rent	11,000	–	–
To General Expenses	17,800	29,000	29,600	By Net Loss	88,450		
To Salaries & Wages	26,800	35,300	40,200				
To Bad Debts	–	6,700	4,200				
To Depreciation of Premises	13,000	–	–				
To Depreciation of Fittings	1,000	2,800	3,200				
To Interest	12,000	–	–				
To Directors' Fee Outstanding	20,000	–	–				
To Auditors' Remuneration outstanding	5,250	–	–				
To Net Profit		1,18,600	95,100				
	99,450	2,02,300	1,83,600		99,450	2,02,300	1,83,600

Trading & Profit and Loss Account
for the year ending 30th June, 2016

Particulars	*Mumbai* ₹	*Delhi* ₹	*Chennai* ₹	Particulars	*Mumbai* ₹	*Delhi* ₹	*Chennai* ₹
To Stock	1,06,400	–	–	By Sales	–	6,76,300	6,14,600
To Purchases	9,56,300	–	–	By Goods sent to Branches:	11,64,000	–	–
To Goods from Head Office	–	6,21,900	5,37,900	By Goods sent to other Branches	–	26,600	14,900
To Goods from other Branches	–	14,300	25,700	By Stock	92,700	40,800	31,500
To Gross Profit c/d	1,94,000	1,07,500	97,400				
	12,56,700	7,43,700	6,61,000		12,56,700	7,43,700	6,61,000
To Rent	–	5,000	6,000	By Gross Profit bid	1,94,000	1,07,500	97,400
To Rates	3,600	4,900	5,300	By Rent	11,000	–	–
To General Expenses	17,800	29,000	29,600	By Goods from Head Office			
To Salaries and Wages	26,800	35,300	40,200	(including goods from and to			
To Bad Debts	–	6,700	4,200	other Branches—Loading)	–	1,01,600	91,450
To Depreciation of Premises	13,000	–	–	By Loss transferred to Profit &			
To Depreciation of Fittings	1,000	2,800	3,200	Loss Appropriation A/c	88,450	–	–
To Interest	12,000	–	–				
To Stock Reserve (on Closing Stock)	–	6,800	5,250				
To Goods sent to Branches – Loading	1,94,000	–	–				
To Directors Fees Outstanding	20,000	–	–				
To Auditors' Remuneration							
Outstanding	5,250	–	–				
To Profit transferred to Profit & Loss							
Appropriation A/c	–	1,18,600	95,100				
	2,93,450	2,09,100	1,88,850		2,93,450	2,09,100	1,88,850

Profit and Loss Account

Particulars	Mumbai ₹	Delhi ₹	Chennai ₹	Particulars	Mumbai ₹	Delhi ₹	Chennai ₹
To Rent	–	5,000	6,000	By Gross Profit as per			
To Rates	3,600	4,900	5,300	Trading A/c	1,94,000	1,07,500	97,400
To General Expenses	17,800	29,000	29,600	By Rent	11,000	–	–
To Salaries and Wages	26,800	35,300	40,200				
To Bad Debts	–	6,700	4,200				
To Depreciation of Premises	13,000	–	–				
To Depreciation of Fittings	1,000	2,800	3,200				
To Interest	12,000	–	–				
To Directors' Fees Outstanding	20,000	–	–				
To Auditors' Remuneration							
Outstanding	5,250	–					
To Net Profit	1,05,550	23,800	8,900				
	2,05,000	1,07,500	97,400		2,05,000	1,07,500	97,400

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Check Your Progress

12. What is the nature of the Head office account maintained by home branch in their books?
13. Mention the adjustment entry to be passed in the books of the branch for the depreciation on branch fixed assets.
14. How does incorporation of Branch Trial Balance in the Head Office Books takes place in abridged incorporation?

13.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. There are several objectives of maintaining departmental accounts:
   - Checking interdepartmental performance
   - Assistance to management in cost control
   - Serving as information for policy formulation in future
2. Preparation of Departmental Accounts is helpful to the business in the following respects:
   (i) It enables the business to compare the performance of one department with that of another.
   (ii) It helps the business in formulating proper policies relating to the expansion of the business. New profitable lines of production or trading can be taken up while the existing lines of production or trading which are giving a loss can be closed down.
   (iii) It helps in appropriate rewarding or penalising the department employees on the basis of the results shown by them.
3. Expenses such as lighting (unless metered separately), rent and rates, wages of night watchman, etc., may be apportioned on this basis.
4. The problems relating to departmental accounts can be put in the following categories:
   1. Problems relating to Departmentalisation of Expenses
   2. Problems relating to Computation of Departmental Costs
   3. Problems relating to Interdepartmental Transfers:
      (a) When such transfers are at cost
      (b) When such transfers are at a price higher than the cost.
5. While preparing the Departmental Trading and Profit and Loss Account, the department receiving the goods or services should be debited with the value of the goods or services so supplied and the department providing such goods or services should be credited with the same amount.

6. The transfer of goods from one department to another is usually at cost.
7. The objectives of branch accounting include to keep an eye on the updated information on the cash position, inventory levels and profit gained and loss suffered by the branch; to stay on top of the performance of the staff at the specific branch and in conjunction disburse the commission accrued for the branch based on the sales and credit.
8. The dependent branches do not maintain full system of accounting.
9. A Stock Ledger is kept to provide information regarding the movement of the goods received from Head Office and the balance of stock in hand.
10. A branch adjustment account is an account for branch transactions maintained for ascertaining the gross profit made at the Branch. All loadings in the goods sent to the branch, opening and closing stocks at the branch and shortage and surplus of stock etc. are recorded in this account.
11. The adjustment entry to be passed by the Head Office for cash in transit in the stocks and debtors system is:

    Cash-in-transit Account Dr.

    To Branch Cash Account
12. The Head Office Account maintained by Home Branch is of the nature of a personal account.
13. The adjustment entry in the books of the branch for the depreciation on branch fixed assets is:

    Depreciation Account Dr.

    To Head Office Account
14. In case of abridged incorporation, the Branch Trading and Profit and Loss Account is prepared by the Head Office as a Memorandum Account only. The entries are passed only for incorporation of the Branch Net Profit or Net Loss and the Branch Assets and Liabilities.

3.9 SUMMARY

- A business may have a number of departments each dealing in a different type of goods. In order to ascertain the profit or loss made by each department, it will be advisable to prepare separately a Trading and Profit and Loss Account of each department at the end of the accounting year. These are referred to as departmental accounts.
- There are several objectives of maintaining departmental accounts: checking interdepartmental performance, assistance to management in

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cost control, serving as information for policy formulation in future, being the ready source of detailed information of the company and its working etc.

- The advantages of departmental accounts are that it enables the business to compare the performance of different departments, helps the business in formulating proper policies relating to the expansion of the business, and it helps in appropriate rewarding or penalizing the department employees on the basis of result shown by them.
- Departmental accounts differ from branch accounts on account of maintenance of account, control, allocation of expenses and reconciliation of accounts etc.
- The preparation of departmental Trading and Profit and Loss Account requires maintenance of proper subsidiary books having appropriate columns for different departments. Some of the examples include Purchases Book, Purchases Returns Book, Sales Book, Sales Return Book, etc.
- Departmentalization of expenses includes the charging of proper share of business expenses to each department for the ascertainment of profit or loss made by each department. The common basis for this include: expenses incurred specifically for a particular department, expenses incurred for the business as a whole but apportioned over different departments and expenses which cannot be allocated or apportioned charged to the total profit.
- The examination problems relating to departmental accounts can be put in the following categories: problems relating to Departmentalization of expenses, computation of departmental costs and problems relating to interdepartmental transfers.
- Transfer of goods or services may take place from one department to another. While preparing the Departmental Trading and Profit and Loss Account, the department receiving the goods or services should be debited with the value of the goods or services so supplied and the department providing such goods or services should be credited with the same amount.
- Branches can be broadly classified into two categories for the purpose of recording transactions in the books of accounts: Dependent Branches and
- Independent Branches including Home Branches and Foreign Branches.
- Some branches keep full system of accounting and these are known as independent branches and the branches who are dependent on the head office for their accounts and do not maintain full system of accounting are known as dependent branches.

- Dependent branch means a branch which does not maintain its own set of books. All records have to be maintained by the Head Office. Its salient features include: it maintains a Debtors' ledger and Stock Ledger; allowance to make purchases from payment by the Head office; daily remittance of cash received from sales to Head office; expenses submitted to Head office and maintenance of petty cash book under imprest system.
- In case of a dependent branch, the Head Office may keep accounts of the Branch according to any of the following systems: Debtors system, Stock and Debtors system, Final Accounts system and Wholesale Branch system.
- In the Debtors system, the head office maintains a branch accounts of a nature of nominal account. It is used for branches of small size.
- In case of Stocks and Debtors system, the Head Office maintains a number of accounts for keeping a record of Branch transactions in place of one branch account.
- Independent branch means a branch which maintains its own set of books. Such a branch can either be a Home Branch or a Foreign branch. The method of accounting is the same in both the cases except that of the consideration of foreign currency in case of foreign branch.
- The characteristics of the accounting system of an independent Home branch include: such a branch has a complete set of its books, prepares its own Trial balance and final accounts and sending of copies to the Head Office, maintenance of a Head Office Account in its books, reconciliation of accounts etc.
- For the consolidated Final Accounts of the Head Office and its branches, there is a necessity for the Head Office of a company to incorporate the Branch balances in its books by means of suitable journal entries. The incorporation can be done through detailed or abridged incorporation.

13.10 KEY WORDS

- **Columnar Subsidiary Book:** It is a book containing separate information for each department regarding each item, e.g., Sales book, Purchases book, etc.
- **Department:** It refers to a division of an organization under the same roof.
- **Stock Reserve:** It represents the unrealised profit included in the stock of a Department or Division.
- **Cash-in-transit:** It refers to cash sent by the Branch to the Head Office or by the Head Office to a Branch, as the case may be, and not received by the other till the end of the accounting period.

- **Dependent Branch:** It is a branch which does not maintain its own set of books.
- **Goods-in-transit:** It refers to goods sent by the Branch or Head Office to the Head Office or Branch, as the case may be, and not received by the other till the end of the accounting period.
- **Independent Branch:** It is a branch which maintains its own set of books.

13.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What are the various objectives of maintaining departmental accounts?
2. How would you differentiate a branch account from a departmental account on the bases of (i) place of maintenance of accounts and (ii) allocation of common expenses?
3. Write a short note on the maintenance of columnar subsidiary books.
4. What are the characteristics of a dependent branch?
5. What is the difference between a branch stock account and a branch cash account?
6. Write a short note on wholesale branch system.
7. State the characteristics of the accounting system of an independent Home Branch.

Long-Answer Questions

1. Differentiate between a Branch and a Department. State the objectives of preparing separate Departmental Accounts.
2. Differentiate between Direct and Indirect Charges in Departmental Accounts. Discuss in brief the allocation of such items at the time of Final Accounts.
3. Differentiate between a Dependent and an Independent Branch. Explain with imaginary data, the accounting entries that are to be passed in the books of the Head Office for incorporating the Branch Trial Balance in the Head Office Books.
4. State the rules for conversion of a foreign branch trial balance in the currency of the Head Office. How would you deal with the difference in exchange resulting on account of such conversion?
5. What are the possible causes of difference between the balances shown

by Head Office Account and Branch Account? Give appropriate Journal entries for reconciliation in the books of H.O. or Branch as the case may be.

6. How will you deal with loss of Stock and Debtors System.

NOTES

13.12 FURTHER READINGS

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UNIT 14 ACCOUNTING FOR HIRE PURCHASE

NOTES

Structure

14.0 INTRODUCTION

The basic tenet on which any market is based is increasing the sales volume and profit. Due to several reasons including the rising standard of life etc., the consumers may want to be able to purchase and make use of goods but may not have the finances to do so. That is to essentially say that the demand may not increase in proportion to the purchasing power. In such case, for the benefit of the vendor and the customer, there can be an arrangement where goods are purchased on hire and used by the customer but the ownership remains with the vendor. This system is known as hire purchase, here the consumer can use the products on his discretion but the ownership will only be transferred to him on payment of all the hire purchase charges and instalments. This ensures that the gap created by the lower purchasing power doesn't disrupt business and the seller takes the benefit of the increased demand for goods. Since, hire purchase transactions span over a period of time with regular payment of instalments, it is important that the accounting for the same is done with great accuracy. In this unit, you will learn about the concept of accounting for hire purchase along with lease accounting.

14.1 OBJECTIVES

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

- Describe the meaning of a hire purchase contract
- Appreciate the importance of cash price for accounting purposes
- Differentiate a hire purchase contract from an instalment purchase contract
- Explain the meaning of default and repossession, complete and partial repossession

14.2 HIRE PURCHASE SYSTEM: OVERVIEW

In this section, we will learn about the basics of the hire purchase system.

14.2.1 Meaning and Features of Hire Purchase System

A contract of hire purchase is a contract where goods are purchased or sold with the stipulations that:

(i) The delivery of goods will be given by the owner of the goods to the hire purchaser

(ii) The payment of the price for the goods will be made in instalments

(iii) Ownership of the goods passes to the hire purchaser only on payment of all the instalments

(iv) In the event of hire purchaser's failure to pay any instalment, the hire vendor will be entitled to seize the goods and adjust the money paid by the hire purchaser against the hire charges for use of goods.

Thus, in a contract of hire purchase, the hire vendor parts only with the possession of goods but not with its ownership. He retains the ownership with him till he receives all the stipulated instalments of hire. The hire purchaser, of course, does not get the ownership but he gets the right to use the goods as per his choice. He will get the ownership only on payment of all the stipulated instalments. He, as a matter of fact, has the option to buy the goods. In case he decides not to buy the goods, he may terminate the contract by refusing to pay all future instalments towards the cost.

The total payment to be made by a buyer in the case of purchase of goods under the system of hire purchase, is always more than the payment that he will have to make in case he buys goods for cash. This is because the hire purchase price, besides cash price of goods, includes the charges for the following:

NOTES

(i) Interest for payment being made over period of time instead of single cash down payment.

(ii) The risk taken by the seller in the event of the buyer's failure to pay the price of goods.

(iii) The registration, insurance and expenses, etc of delivering the goods.

The difference between the hire purchase price and the cash price is known by different names. Some people call it hire purchase charges, while others call it finance charges, still others simply as interest. A proper distinction between cash price and other charges paid by the hire purchaser is to be made for accounting purposes. This is to being explained later in the chapter.

14.2.2 Hire Purchase Agreement

The Hire Purchase Act, 1972 was enacted by the Parliament to define and regulate the rights and duties of the parties to the hire purchase. The Act was to be enforced from 1 September 1973. However due to objections from various sections of public the Act remained in dormant state in the statute book and was never enforced. The Hire Purchase Act was finally repealed w.e.f. 23 June 2005 by enactment of his The Hire Purchase (Repeal), Act 2005.

A contract of Hire Purchase is now governed by the provisions of Chapter IX of the Indian Contract Act, 1872. Chapter IX deals with Contracts of Bailment. A 'bailment' is the delivery of goods by one person to another for some purpose, under the contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the persons delivering them. A hire purchase agreement is also a form of bailment in which the hirer is given the right to purchase only on certain terms and conditions. However, to purchase is only an option, not an obligation. If the hirer elects to purchase the goods, the title will pass to him once he fulfills all the conditions prescribed in the agreement. In case he does not elect to purchase the goods, he is entitled to return the goods and terminate the agreement in the manner provided therein.

Termination of Hire Purchase Agreement

A hire purchase agreement can be terminated in any of the following ways:

(i) **By agreement:** The hire purchase agreement stipulates the circumstances in which the agreement can generally terminate by return of the goods by the hirer, in any case the hire purchase agreement can be terminated by mutual agreement.

(ii) **By performance:** The hire purchase agreement is terminated by performance on the exercise of the option to the purchase the goods by the hirer.

(iii) **By renewal:** The parties to an agreement may enter into a fresh agreement terminating the hire purchase agreement, which has not already been terminated.

(iv) **By acceptance of repudiation by other party:** An agreement is terminated, when a party to an agreement renounces his future obligations under the agreement or commits a breach of the agreement, which indicates that he does not want to remain bound by its provisions, and the other party accepts the renunciation or breach as discharging.

(v) **By release:** Where one party to an agreement releases the other party from the performance of the obligations by him under the agreement, the agreement carries to an end.

(vi) **By supervening impossibility:** When performance of the agreement becomes impossible by reason of some act or event occurring subsequent to the formation of the agreement, the contract will come to an end and the parties will be discharged from further obligations under the agreement, For example if the goods are destroyed during the currency of hire-purchase agreement without negligence on the part of the hirer, the agreement comes to an end.

(vii) **By efflux of time:** When the hirer is giving time to exercise option to purchase the goods within a stated period and the hire purchaser does not exercise the option within the said period, the agreement comes to an end.

NOTES

Remedies in Case of Breach

In case of breach of the hire purchase agreement, the owner is entitled to any of the following remedies against the hirer:

(i) He can recover the goods by physical repossession; or

(ii) He can abandon any claim to the goods and sue the hirer for damages.

Registration

The registration of a hire purchase agreement is not necessary, as no immovable property is conveyed thereby to the hirer.

System of Accounting Records

The system of maintaining accounting records for hire purchase transactions is different in each of the following circumstances:

(i) When goods of substantial sales value are the subject matter of sale, *e.g.,* trucks, heavy machinery etc.

(ii) When goods of small sales value are the subject matter of sale, *e.g.,* radios, television sets, refrigerators etc.

NOTES

Check Your Progress

1. List the terms used for the difference between hire purchase price and cash price.
2. Give an example of a situation where the hire purchase agreement terminates due to supervening impossibility.

14.3 HIRE PURCHASE AND SALE: GOODS OF SUBSTANTIAL SALES VALUE

In case of hire purchase transactions relating to goods of substantial sales value, a proper distinction has to be made between: (i) Cash Price of the Goods and (ii) Hire Purchase Charges, which are generally categorised as Interest.

This distinction is particularly important for the hire purchaser, since the Cash Price paid by him for the goods is an expenditure of a capital nature and, therefore, has to be debited to the concerned Asset Account while the amount paid as interest is a revenue expenditure which is ultimately to be charged to the Profit and Loss Account.

14.3.1 Calculation of Interest

Different techniques may have to be adopted for calculation of interest depending upon the information given in the examination problem.

On the basis of the type of the information given, the examination problems can be classified as follows:

(a) *When Cash Price, Rate of Interest, Hire Purchase Price and Number of Instalments etc. are all given.* In case of this type of examination problem, the calculation of interest is not a difficult task. The interest is to be calculated on the outstanding balance of the cash price at the stipulated rate. The only point that, has to be taken care of is that since the instalments are in round sums of money, the interest for the final period, should be taken as the difference between the cash price outstanding at the end of that period and the amount of instalment. This will be clear with the following illustration:

Illustration 14.1: *X* purchases a car from *B* whose cash price is ₹ 60,000 on 1st Jan. 2013. ₹ 20,000 is paid at the signing of the contract and the balance is to be paid in three equal annual instalments of ₹ 20,000 each. The rate of interest being 22% p.a.

You are required to calculate the amount of interest included in each instalment.

NOTES

Solution

			₹
	Cash Price of the car		60,000
Less:	Amount paid at the signing of the contract		20,000
			40,000
Add:	Interest @ 22% p.a. for 2013 (40,000 × 22/100)		8,800
		Total	48,800
Less:	Instalment paid at the end of 2013		20,000
			28,800
Add:	Interest @ 22% p.a. for 2014 (28,800 × 22/100)		6,336
		Total	35,136
Less:	Instalment paid at the end of 2014		20,000
			15,136
Add:	Interest @ 22% p.a. for 2015 (balancing figure)		4,864 *
			20,000
	Instalment paid at the end of 2015		20,000
			Nil

(b) *If Rate of Interest is not given.* In case the information about rate of interest is not given in an examination problem, the interest included in each instalment will be calculated on the basis of the hire purchase price outstanding in the beginning of each year.

Illustration 14.2: On the basis of the data given in Illustration 14.1, calculate the amount of interest for each year if the rate of interest has not been given.

Solution

	₹
Hire Purchase Price	80,000
Cash Price	60,000
Interest	20,000

Since the rate of interest is not given, the amount of interest of ₹ 20,000 will be bifurcated over three years in the ratio of hire purchase price outstanding in the beginning of each year.

			₹
Year 2013		Hire Purchase Price	80,000
	Less:	Cash Down payment	20,000
		Hire Purchase Price outstanding in the beginning of 2013	60,000
	Less:	Instalment paid at the end of 2013	20,000
		Hire Purchase Price outstanding in the beginning of 2014	40,000
	Less:	Instalment paid at the end of 2014	20,000
		Hire Purchase Price outstanding in the beginning of 2015	20,000

The amount of interest of ₹ 20,000 will therefore be apportioned in the ratio of 3 : 2 : 1 (*i.e.,* in the ratio of Outstanding Hire Purchase Instalments). Interest for each year will be as follows:

2013	20,000 × 3/6	=	10,000
2014	20,000 × 2/6	=	6,667
2015	20,000 × 1/6	=	3,333
			20,000

NOTES

(c) *If Cash Price is not given*. In case in an examination problem the Cash Price is not given, interest as well as Cash Price will be calculated by working backwards.

Illustration 14.3: On the basis of the data given in Illustration 14.1, calculate cash price and the interest if all information except cash price have been given.

Solution

Year	*Amount due at the end of the year*	*Instalment paid*	*Total amount due at the end of the year*	*Interest @ 22/122*	*Principal or amount due in the beginning of the year*
2015	—	20,000	20,000	3,607	16,393
2014	16,393	20,000	36,393	6,563	29,830
2013	29,830	20,000	49,830	8,986	40,844
	Cash down payment	20,000			60,844

Working Notes:

1. Interest is charged on cash price. Instalment paid at the end of 2015 includes interest on the principal amount outstanding in the beginning of 2015 @ 22%. It means that in every payment of ₹ 122, ₹ 100 is the principal and ₹ 22 is the interest. The amount of interest included in ₹ 20,000 can, say, therefore, be ascertained as follows:

$$20,000 \times \frac{22}{122} = 3,607$$

The principal amount outstanding in the beginning of 2015, therefore, comes to ₹ 16,393.

2. At the end of 2014 the total amount due to ₹ 36,393 (i.e., ₹ 16,393 + ₹ 20,000). This includes interest for 2014. The amount of this interest can be calculated as follows:

$$36,393 \times \frac{22}{122} = 6,563$$

Similarly, the amount of interest for 2013 has been calculated, i.e.,

$$49,830 \times \frac{22}{122} = 8,986$$

The principal amount outstanding in the beginning of 2013 comes to ₹ 40,844. A sum of ₹ 20,000 has been paid as Cash Down Payment. Hence Cash Price comes to ₹ 60,844.

14.3.2 Accounting Entries in the Books of Hire Purchaser

The accounting entries for recording of hire purchase transactions in the books of both the hire purchaser and the hire vendor are being explained in the following pages.

NOTES

Books of the Hire Purchaser

There are two methods for making accounting entries of the hire purchase transactions in the books of the hire purchaser:

(1) When asset is recorded at full cash price; and

(2) When asset is recorded at the cash price actually paid

(1) ***When asset is recorded at full cash price:*** In case of this method, the entries regarding hire purchase transactions are recorded on this basis that having agreed to buy the asset, the hire purchaser has become practically (of course, not technically), the full owner of the asset. The following journal entries are passed in the books of the buyer for recording hire purchase transactions according to this method:

(i) *On Purchase of the Asset:*
Asset Account *Dr.*
To Hire Vendor
(with full cash price of the asset)

(ii) *On Making Cash Down Payment:*
Hire Vendor *Dr.*
To Cash/Bank
(with actual cash down payment)

(iii) *For Interest Due:*
Interest Account *Dr.*
To Hire Vendor
(Interest is calculated on the outstanding amount when instalment becomes due)

(iv) *On Payment of Hire Purchase Instalment:*
Hire Vendor Account *Dr.*
To Cash/Bank Account
(with amount paid)

(v) *For Depreciation of the Asset:*
Depreciation Account *Dr.*
To Asset Account
(At the end of the accounting period)

At the end of the accounting period, the total amount of interest due to the hire vendor and depreciation of the asset are transferred to the Profit and Loss Account. In case any expenditure is incurred on repairs of the asset, the amount will also be charged to the Profit and Loss Account of the year in which such repairs are done. At the end of the accounting year, the asset account and the vendor's account will appear in the Balance Sheet as follows:

Liabilities	₹	*Assets*	₹
		Asset (after depreciation)	....
		Less: Amount due to Hire Vendor	....
			....

NOTES

(2) ***When asset is recorded at the cash price actually paid:*** This method recognises the fact that the hire purchaser does not become the owner of the asset till he makes payment of the final instalment. Hence, no entry is passed when agreement for hire purchase is signed. Entries are passed at the time of payment of each instalment.

The following journal entries are passed for hire purchase transactions according to this method:

(i) *On Cash Down Payment:*
Asset Account *Dr.*
To Cash/Bank
(with the amount of cash down payment)

(ii) *On Hire Purchase Instalment becoming Due:*
Asset Account *Dr.*
Interest Account *Dr.*
To Hire Vendor
(Asset Account is debited with the amount of cash price included in each instalment. The interest on outstanding cash price is debited to the Interest Account)

(iii) *On Making Payment of the Instalment:*
Hire Vendor *Dr.*
To Cash/Bank
(with the amount of instalment paid)

(iv) *For Depreciation of the Asset:*
Depreciation Account *Dr.*
To Asset Account
(Depreciation is charged on the full cash price of the asset, since the Hire Purchaser is making full use of the asset)

At the end of the accounting year, the total amount of interest due to hire vendor and depreciation of the asset will be transferred to the Profit and Loss Account as is done in the case of 1st method. Since hire vendor's account is credited only with the amount of instalment due and not with the full cash price and, therefore, there will be no balance in his account once the instalment due is paid to him. The asset account will appear in the Balance Sheet as follows:

Liabilities	₹	*Assets*	₹
		Asset (after depreciation)	....

Tutorial Note: It may be noted that in case of Method (2), a Memorandum Hire Vendor's Account will have to be prepared for calculating the amount of interest when each instalment becomes due. This account will be prepared on the same pattern on which the hire vendor's account is prepared in case of 1st method. This results in extra clerical work. The students are, therefore, advised to follow the 1st method, unless otherwise specified.

NOTES

14.3.3 Accounting Entries in the Books of the Hire Vendor

The Hire Vendor takes the sale of goods on hire purchase as an ordinary sale. He, therefore, debits the account of the hire purchaser and credits the sales account with the full cash price as soon as the contract is signed. Entries for interest are passed periodically.

The journal entries to be passed by the hire vendor are as follows:

(i) *On Sale of Goods under Hire Purchase:*
Hire Purchaser Account *Dr.*
To Sales Account
(with full cash price)

(ii) *On Receiving Cash Down Payment:*
Cash/Bank Account *Dr.*
To Hire Purchaser
(with the amount of cash down payment)

(iii) *For Interest Due:*
Hire Purchaser Account. *Dr.*
To Interest Account
(Interest is calculated when instalment becomes due on the outstanding balance in the account of the hire purchaser)

(iv) *On Getting Payment of the Instalment:*
Cash/Bank Account *Dr.*
To Hire purchaser
(with the amount of instalment received)

Illustration 14.4: On 1st January, 2011 *A* Ltd. purchased from *B* Ltd. five trucks under hire purchase system, ₹ 50,000 being paid on delivery and the balance in five instalments of ₹ 75,000 each payable annually on 31st Dec. The vendor charges 5 per cent per annum interest on yearly balances. The cash price of the five trucks was ₹ 3,75,000.

Show how this transaction should be recorded in the books of both companies, if *A* Ltd. writes off depreciation at 10 per cent per annum on the written-down value. Also show how the items will appear in the Balance Sheet as on 31st December, 2011.

You may round the interest amount to the nearest ten.

Solution

Books of A Ltd. (First Method)
Trucks Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2011			2011		
Jan. 1	To Balance b/d	3,75,000	Dec. 31	By Depreciation	37,500
				By Balance c/d	3,37,500
		3,75,000			3,75,000
2012			2012		
Jan. 1	To Balance b/d	3,37,500	Dec. 31	By Depreciation	33,750
				By Balance c/d	3,03,750
		3,37,500			3,37,500

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
Jan. 1	To Balance b/d	3,03,750	Dec. 31	By Depreciation	30,380
				By Balance c/d	2,73,370
		3,03,750			3,03,750
2014			2014		
Jan. 1	To Balance b/d	2,73,370	Dec. 31	By Depreciation	27,340
				By Balance c/d	2,46,030
		2,73,370			2,73,370
2015			2015		
Jan. 1	To Balance b/d	2,46,030	Dec. 31	By Depreciation	24,600
				By Balance c/d	2,21,430
		2,46,030			2,46,030

B LTD.

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2011			2011		
Jan. 1	To Cash	50,000	Jan. 1	By Truck Account	3,75,000
Dec. 31	To Cash	75,000	Dec. 3	By Interest A/c	
	To Balance c/d	2,66,250		(5% on ₹ 3,25,000)	16,250
		3,91,250			3,91,250
2012			2012		
Dec. 31	To Cash	75,000	Jan. 1	By Balance b/d	2,66,250
	To Balance c/d	2,04,560	Dec. 31	By Interest A/c	
				(5% on ₹ 2,66,250)	13,310
		2,79,560			2,79,560
2013			2013		
Dec. 31	To Cash	75,000	Jan. 1	By Balance b/d	2,04,560
	To Balance c/d	1,39,790	Dec. 31	By Interest A/c	
				(5% on ₹ 2,04,560)	10,230
		2,14,790			2,14,790
2014			2014		
Dec. 31	To Cash	75,000	Jan. 1	By Balance b/d	1,39,790
	To Balance c/d	71,780	Dec. 31	By Interest A/c	
				(5% on ₹ 1,39,790)	6,990
		1,46,780			1,46,780
2015			2015		
Dec. 31	To Cash	75,000	Jan. 1	By Balance b/d	71,780
			Dec. 31	By Interest A/c	
				(5% on ₹71,780)	3,220
		75,000			75,000

NOTES

Interest Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2011			2011		
Dec. 31	To *B* Ltd.	16,250	Dec. 31	By Profit & Loss A/c	16,250
2012			2012		
Dec. 31	To *B* Ltd.	13,310	Dec. 31	By Profit and Loss A/c	13,310
2013			2013		
Dec. 31	To *B* Ltd.	10,230	Dec. 31	By Profit and Loss A/c	10,230
2014			2014		
Dec. 31	To *B* Ltd.	6,990	Dec. 31	By Profit and Loss A/c	6,990
2015			2015		
Dec. 31	To *B* Ltd.	3,220	Dec. 31	By Profit and Loss A/c	3,220

Balance Sheet
as on 31st Dec., 2011

Liabilities	₹	*Assets*		₹
		Trucks on hire purchase	3,75,000	
		Less: Depreciation	37,500	
			3,37,500	
		Less: Due to *B* Ltd.	2,66,250	71,250

Books OF A Ltd. (Second Method)
Trucks Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2011			2011		
Jan. 1	To Cash	50,000	Dec. 31	By Depreciation	
Dec. 31	To Cash	58,750		(10% on 3,75,000)	37,500
				By Balance c/d	71,250
		1,08,750			1,08,750
2012			2012		
Jan. 1	To Balance b/d	71,250	Dec. 31	By Depreciation	
Dec. 31	To Cash	61,690		(10% on 3,37,500)	33,750
				By Balance c/d	99,190
		1,32,940			1,32,940
2013			2013		
Jan. 1	To Balance b/d	99,190	Dec. 31	By Depreciation	
Dec. 31	To Cash	64,770		(10% on 3,03,800)	30,380
				By Balance c/d	1,33,580
		1,63,960			1,63,960
2014			2014		
Jan. 1	To Balance b/d	1,33,580	Dec. 31	By Depreciation	
Dec. 31	To Cash	68,010		(10% on 2,73,400)	27,340
				By Balance c/d	1,74,250
		2,01,590			2,01,590
2015			2015		
Jan. 1	To Balance b/d	1,74,250	Dec. 31	By Depreciation	
Dec. 31	To Cash	71,780		(10% on 2,46,000)	24,600
				By Balance c/d	2,21,430
		2,46,030			2,46,030

NOTES

Interest Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2011			2011		
Dec. 31	To Cash	16,250	Dec. 31	By Profit and Loss A/c	16,250
2012			2012		
Dec. 31	To Cash	13,310	Dec. 31	By Profit and Loss A/c	13,310
2013			2013		
Dec. 31	To Cash	10,230	Dec. 31	By Profit and Loss A/c	10,230
2014			2014		
Dec. 31	To Cash	6,990	Dec. 31	By Profit and Loss A/c	6,990
2015			2015		
Dec. 31	To Cash	3,220	Dec. 31	By Profit and Loss A/c	3,220

Balance Sheet
as on 31st Dec., 2011

Liabilities	₹	*Assets*		₹
		Truck on hire purchase		
		at Cost	1,08,750	
		Less: Depreciation	37,500	71,250

Books of B Ltd.
A Ltd.

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2011			2011		
Jan. 1	To Sales A/c	3,75,000	Jan. 1	By Cash	50,000
Dec. 31	To Interest A/c	16,260	Dec. 31	By Cash	75,000
			Dec. 31	By Balance c/d	2,66,250
		3,91,250			3,91,250
2012			2012		
Jan. 1	To Balance b/d	2,66,250	Dec. 31	By Cash	75,000
Dec. 31	To Interest A/c	13,310		By Balance c/d	2,04,560
		2,79,560			2,79,560
2013			2013		
Jan. 1	To Balance b/d	2,04,560	Dec. 31	By Cash	75,000
Dec. 31	To Interest A/c	10,230		By Balance c/d	1,39,790
		2,14,790			2,14,790
2014			2014		
Jan. 1	To Balance b/d	1,39,790	Dec. 31	By Cash	75,000
Dec. 31	To Interest A/c	6,990		By Balance c/d	71,780
		1,46,780			1,46,780
2015			2015		
Jan. 1	To Balance b/d	71,780	Dec. 31	By Cash	75,000
Dec. 31	To Interest A/c	3,220			
		75,000			75,000

NOTES

Sales Account

Date	Particulars	₹	Date	Particulars	₹
2011			2011		
Dec. 31	To Trading A/c	3,75,000	Jan. 1	By *A* Ltd.	3,75,000

Interest Account

Date	Particulars	₹	Date	Particulars	₹
2011			2011		
Dec. 31	To Profit and Loss A/c	16,250	Dec. 31	By *A* Ltd.	16,250
2012			2012		
Dec. 31	To Profit and Loss A/c	13,310	Dec. 31	By *A* Ltd.	13,310
2013			2013		
Dec. 31	To Profit and Loss A/c	10,230	Dec. 31	By *A* Ltd.	10,230
2014			2014		
Dec. 31	To Profit and Loss A/c	6,990	Dec. 31	By *A* Ltd.	6,990
2015			2015		
Dec.	To Profit and Loss A/c	3,220	Dec. 31	By *A* Ltd.	3,220

14.3.4 Default and Repossession: Complete and Partial

In case the hire purchaser fails to make payment of any instalment, the hire vendor may seize the goods and forfeit all amounts paid by the hire purchaser so far.

Seizure of the goods may be partial or full depending on the circumstances and the agreement between the parties. Of course, in case of partial seizure, only a part of the amount paid by the hire purchaser will be forfeited by the hire vendor. The hire vendor may, after seizing the goods, spend some money on the goods for getting them repaired or reconditioned and later on sell them.

The journal entries to be passed in the books of the parties are as follows:

Books of Buyer

(i) Usual entries for interest and depreciation till due date of the instalment should be passed, as explained in the preceding pages.

(ii) In case of full seizure of the asset by the hire vendor, any amount standing to the credit of the hire vendor will be transferred to the asset account. Any balance in the asset account will be transferred to the Profit and Loss Account.

(a) *For transferring the balance of the Vendor's Account:*
Hire Vendor *Dr.*
To Asset Account

(b) *For transferring the balance of the Asset Account:*
Profit and Loss Account *Dr.*
To Asset Account

Alternatively, any balance to the debit of the asset account may be transferred to the hire vendor's account. Any balance in the hire vendor's account will be transferred to Profit and Loss Account. Normally an account having a smaller balance is transferred to an account having a bigger balance.

Generally, there is always a loss to the hire purchaser on the seizure of the goods by the hire vendor and hence, this is written off from the Profit and Loss Account. In case, there is a profit, a reverse entry will be passed.

(iii) The hire vendor may not be so harsh to take possession of the full asset. He may leave a portion of the asset with the hire purchaser. In such a case, an agreement is made regarding the value at which the seized asset will be taken back by the hire vendor. The value so agreed will be debited to the hire vendor and credited to the asset account. Such value is generally lower than the value at which the asset is appearing in the books of the hire purchaser. The difference between the book value of the asset and the value at which it has been taken over by the hire vendor is a loss which will be written off from the Profit and Loss Account.

Books of Hire Vendor

(i) The Hire Vendor will pass usual entry for the interest due from the hire purchaser till the due of the instalment.

(ii) *On Repossession of Goods:*

Goods Repossessed Account *Dr.*
  To Hire Purchaser
(with the amount due from the hire purchaser or in case of partial seizure with the value agreed)

(iii) *For Repairs etc. of the Goods Repossessed:*

Goods Repossessed Account *Dr.*
  To Bank

(iv) *On selling of the goods repossessed*:

Cash/Bank *Dr.*
  To Goods Repossessed Account

(v) Any profit or loss on sale of repossessed goods will be transferred to the Profit & Loss Account.

For Loss: Profit and Loss Account *Dr.*
  To Goods Repossessed Account
In case of Profit: The entry will be reversed

Complete Seizure of Goods

Illustration 14.5: On 1st January, 2013, Ashok acquired furniture on the hire purchase system from Real Aids Ltd., agreeing to pay four semi-annual instalments of ₹ 800 each, commencing on 30th June, 2013. The Cash Price of the items was ₹ 3,010 and interest of 5% per annum was chargeable.

On 30th September, 2013, Ashok expresses his inability to continue and Real Aids Ltd. seized the property. It was agreed that Ashok would pay the due proportion of the instalment upto the date of seizure and also a further sum of ₹ 200 towards depreciation. At the time of re-possession, Real Aids Ltd. valued the furniture at ₹ 1,500.

The company after incurring ₹ 200 towards repairs of the furniture, sold the items for ₹ 1,800 on 15th October, 2013.

Solution

Books of Ashok (First Method)
Furniture Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
Jan.	To Real Aids Ltd.	3,010	Sep. 30	By Depreciation (10% on ₹ 3,010 for 9 months)	225.75
				By Real Aids Ltd.	2,784.25
		3,010			3,010,00

Real Aids Ltd.

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
June 30	To Cash A/c	800	Jan. 1	By Furniture A/c	3,010
Sept.30	To Cash A/c (₹ 400 + ₹ 200)	600	Jan. 30	By Interest	75.25
Sept. 30	To Furniture A/c	2,784.25	Sept. 30	By Interest A/c (on ₹ 2,285 @ 5% p.a.)	28.57
			Sept. 30	By Profit & Loss A/c (loss on seizure of asset)	1,070.43
		4,184.25			4,184.25

Interest A/c

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
June 30	To Real Aids	75.25	Sept. 30	By Profit and Loss Account	103.82
Sept. 30	To Real Aids Ltd.	28.57			
		103.82			103.82

Profit and Loss Account (Extracts)

Particulars	₹	*Particulars*	₹
To Interest	103.82		
To Loss on seizure of goods	1,070.43		
To Dep. on Furniture	225.75		
	1,400,00		

NOTES

Second Method

Furniture Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
June 30	To Real Aids Ltd.	724.75	Sept. 30	By Depreciation (10% on	
Sept. 30	To Real Aids Ltd			3,010 for 9 months)	225.75
	(₹ 600 – ₹ 28.57)	571.43	Sept. 30	By Profit and Loss A/c	
				(loss on seizure of asset)	1,070.43
		1,296.18			1,296.18

Real Aids Ltd.

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
June 30	To Cash A/c	800	Jan. 1	By Furniture A/c	724.75
Sept. 30	To Cash A/c	600	Jan. 30	By Interest A/c	75.25
			Sept. 30	By Furniture A/c	571.43
			Sept. 30	By Interest A/c	28.57
		1,400			1,400.00

The Interest Account and Profit and Loss Account will be prepared in the same way as in case of First Method.

Books of Real Aids Ltd.

Ashok's Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
Jan. 1	To Hire Purchase Sales	3,010.00	Jan 30	By Bank	800.00
June 30	To Interest A/c		Sept. 30	By Bank	600.00
	(on ₹ 3,010)	75.25	Sept. 30	By Profit & Loss Account	
				(loss on valuation of	
				goods repossessed)	213.82
2013			2013		
Sept. 30	To Interest		Sept. 30	By H.P. Goods	
	(on ₹ 2,285.25)	28.57		Repossessed Account	1,500.00
		3,113.82			3,113.82

Hire Purchase Goods Repossessed Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
Sept. 30	To Ashok	1,500	Oct. 15	By Cash A/c (Sales)	1,800
Sept 30	To Cash (Expenses)	200			
Oct. 15	To Profit and Loss A/c	100			
	(Profit on repossessed				
	goods sold)				
		1,800			1,800

NOTES

Profit and Loss Account (Extracts)

Date	*Particulars*	₹	*Date*	*Particulars*	₹
	To Loss on valuation of goods repossessed	213.82		By Interest on H.P. Sales	103.82
				By Hire-Purchases Goods Repossessed A/c (Profit)	100.00
				By Profit and Loss A/c	10.00
		213.82			213.82

Full as well as Partial Seizure of Goods

Illustration 14.6: On 1st January, 2014, five trucks were purchased by *A* on the hire purchase system. The cash price of each truck is ₹ 55,000. The payment was to be made as follows:

10% of the cash price down.

25% of the cash price at the end of each of the four subsequent half-years.

The payment due on 31st December, 2014 could not be made. You are required to prepare the necessary ledger account in the books of both parties under each of following situations:

(i) The vendor seizes all the trucks, spends ₹ 15,000, on their repairs and sells two of them for ₹ 95,000.

(ii) The vendor allows *A* to keep three trucks on the condition that the value of the other two trucks would be adjusted against the amount due. The trucks being valued at cost *less* 25% depreciation. The vendor spends ₹ 6,000 on thoroughly overhauling the trucks and sells them for ₹ 95,000.

A charges depreciation at 15% p.a. on original cost and closes his books on 30th June, each year.

Solution

Basic Calculations	₹
Cash price of trucks (5 × 55,000)	2,75,000
Cash down payment (10% of Cash Price)	27,500
Instalment 25% of Cash Price	68,750
Total Interest (i.e., 10% of cash price-paid extra)	27,500

Since the rate of interest has not been given, the amount of interest included in each instalment will be ascertained by dividing the total interest in the ratio of hire purchase price outstanding in the beginning of each period. The ratio comes to 4:3:2:1.

Instalment		*Interest*
1st	4/10 × 27,500	11,000
2nd	3/10 × 27,500	8,250
3rd	2/10 × 27,500	5,500
4th	1/10 × 27,500	2,750

NOTES

The ledger accounts can now be prepared as follows:

(i) When all trucks are seized:

Books of A (Hire Purchaser)
Trucks Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
Jan. 1	To Vendor	2,75,000	June 30	By Depreciation A/c	20,625
			June 30	By Balance c/d	2,54,375
		2,75,000			2,75,000
2014			2014		
July 1	To Balance b/d	2,54,375	Dec. 31	By Depreciation A/c	20,625
			Dec. 31	By Hire Vendor's A/c	2,33,750
		2,54,375			2,54,375

Hire Vendor's Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
Jan. 1	To Cash A/c (Cash down)	27,500	Jan. 1	By Trucks A/c	2,75,000
June 30	To Cash	68,750	June 30	By Interest	11,000
June 30	To Balance c/d	1,89,750			
		2,86,000			2,86,000
2014			2014		
Dec. 31	To Trucks A/c	2,33,750	July 1	By Balance b/d	1,89,750
			Dec. 31	By Interest A/c	8,250
				By Profit & Loss Account (loss on seizure of trucks— balancing figure)	35,750
		2,33,750			2,33,750

Books of the Hire Vendor
A's Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
Jan. 1	To Sales A/c	2,75,000	Jan. 1	By Cash	27,500
June 30	To Interest A/c	11,000	June 30	By Cash	68,750
			June 30	By Balance c/d	1,89,750
		2,86,000			2,86,000
2014			2014		
July 1	To Balance b/d	1,89,750	Dec. 31	By Goods Repossessed A/c	1,98,000
	To Interest A/c	8,250			
		1,98,000			1,98,000

Goods Reprocessed Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2004		
Dec. 31	To *A*	1,98,000	Dec. 31	By Cash (sale of 2 trucks)	95,000
Dec. 31	To Cash (expenses on repairs)	15,000	Dec. 31	By Balance c/d (3/5 × 2,13,000)	1,27,800

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To P & L A/c (Profit on of goods repossessed)	9,800			
		2,22,800			2,22,800

NOTES

(ii) When only two trucks are seized

Books of A (Hire Purchaser)
Trucks Account

Date	Particulars	₹	Date	Particulars	₹
2014			2014		
Jan. 1	To Hire Vendor	2,75,000	June 30	By Depreciation Account	20,625
				By Balance c/d	2,54,375
		2,75,000			2,75,000
2014			2014		
July 1	To Balance b/d	2,54,375	Dec. 31	By Depreciation Account	20,625
				By Hire Vendor	82,500
				By Profit & Loss Account (loss on seizure of trucks)	11,000
				By Balance c/d	1,40,240
		2,54,375			2,54,375

Hire Vendor's Account

Date	Particulars	₹	Date	Particulars	₹
2014			2014		
Jan. 1	To Bank (Cash down)	27,500	Jan. 1	By Trucks Account	2,75,000
June 30	To Bank	68,750	June 30	By Interest	11,000
June 30	To Balance b/d	1,89,750			
		2,86,000			2,86,000
2014			2014		
Dec. 31	To Trucks Account	82,500	July 1	By Balance b/d	1,89,750
Dec. 31	To Balance b/d	1,15,500	Dec. 1	By Interest A/c	8,250
		1,98,000			1,98,000

Working Note:

Loss on Trucks seized	₹
Book Value of the trucks as per *A*'s books (₹ 1,10,000 *less* Dep. @ 15% on original cost ₹ 16,500)	93,500
Value at which trucks have been taken by the vendor (₹ 1,10,000 *less* Dep. @ 25% ₹ 27,500)	82,500
Loss	11,000
Alternatively, Book Value of 5 trucks on Dec. 31, 2014 (after depreciation)	2,33,750
Less: Book Value of 3 trucks on Dec. 31, 2014 (3/5 × 2,33,750) with the purchaser	1,40,250
Book Value of two trucks seized	93,500
Less: Value at which seized trucks have been taken	82,500
Loss	11,000

NOTES

Books of Hire Vendor
A's Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
Jan. 1	To Sales Account	2,75,000	Jan. 1	By Cash	27,500
June 30	To Interest A/c	11,000	June 30	By Cash	68,750
			June 30	By Balance c/d	1,89,750
		2,86,000			2,86,000
2014			2014		
July 1	To Balance b/d	1,89,750	Dec. 31	By Goods Repossessed Account	82,500
Dec. 31	To Interest Account	8,250			
			Dec. 31	By Balance c/d	1,15,500
		1,98,000			1,98,000

Goods Repossessed Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
Dec. 31	To *A*	82,500	Dec. 31	By Sales (Cash)	95,000
Dec. 31	To Cash (Expenses)	6,000			
Dec. 31	To P & L A/c (Profit)	6,500			
		95,000			95,000

Check Your Progress

3. How is the interest calculated for goods of substantial sales value when the rate of interest is not given?
4. Mention the journal entry in the books of hire vendor in case of interest due.
5. Mention the journal entry to be passed in the books of hire vendor.

14.4 HIRE PURCHASE AND SALE: ACCOUNTING RECORDS FOR GOODS OF SMALL SALES VALUE

In those cases where the goods sold on hire purchase are of small sales value, the transactions are numerous and the parties of agreement vary, it is necessary to have a simple but adequate system of maintaining record of hire purchase transactions. For example, hire vendor may be selling T.V. sets, radio sets, washing machines and fans etc. on hire purchase. These articles are of small sales value and are sold under varying hire purchase agreements. The number of customers, instalments etc. is also quite large. The purchasers are individuals who do not maintain any set of books. Hence, the transactions are to be recorded in the books of the vendor only.

NOTES

It may not be possible for the vendor to keep an account of each individual customer to whom he has sold the goods on hire purchase. He generally maintains a Memorandum record of the hire purchase transactions in a Hire Purchase Sales Register with appropriate columns as shown in the proforma on the next page.

The total of various columns are posted to different accounts periodically. Thus, the double entry is completed only by means of periodical totals.

At the end of the accounting period, the following information is collected from the hire purchase sales register:

1. ***Cost Price of the Goods Sold on Hire Purchase:*** This may properly be called as Cost of Goods Sent on Hire Purchase since the actual sales should be taken only to the extent of cost equivalent of the instalments due on the goods sold on hire purchase.
2. ***Value of Goods Sold on Hire Purchase:*** This may also be properly termed as Value of Goods Sent on Hire Purchase since the actual sales are only to the extent of the hire purchase instalments due in respect of the year.
3. ***Cash Received:*** This is the total of the cash down payment and the amount of instalment paid by the hire purchase customer during the accounting year.
4. ***Total Instalments Due but Unpaid:*** This is the total of the amount of instalments which have become due during the accounting year but has not been paid by the customers. The terms *"Hire Purchase Debtors", "Instalments Due, Customers Paying"* have also the same meaning. Total of the cash received and instalments due but unpaid is the amount of real sales which have been made during the accounting year.
5. ***Total Amount of "Instalments Not Yet Due":*** This is the total amount of those instalments in respect of goods sold on hire purchase which are to be received in the next accounting period. They have not yet become due by the end of the accounting period. The terms *"Hire Purchase Stock", "Stock with the Customers", "Instalments Not Yet Due"* have also the same meaning. A specimen of Hire Purchase Register is given on the next page.

NOTES

Hire Purchase Sales Register*
for the year ended 31st December, 2015

S. No.	*Date of Agreement*	*Name of Article*	*Name of Customer*	*Cost price*	*Hire Purchase*	*Cash Down Payment*	*No. of Instalments*	*Instalments Due*			*Total Instalment*	*Instalments due but unpaid*	*Instalments not yet due*
								1	*2*	*3*			
				₹	₹	₹	₹	₹	₹	₹	₹	₹	₹
1.	1.1.2015	T.V. Set	*X*	3,000	4,500	1,500	20	150	150	150	450	—	2,550
2.	1.4.2015	Radiogram	*Y*	3,000	5,000	2,000	10	300	300	300	600	300	2,100
3.													
4.													
5.													
				6,000	9,500	3,500		450	450	450	1,050	300	4,650

.All figures are imaginary *

From the data given in the specimen of the Hire Purchase Sales Register the amounts in respect of each of the above items for the year 2015 are as follows:

		₹
(i)	Cost Price of Goods Sold on Hire Purchase	6,000
(ii)	Value of the Goods Sold on Hire Purchase	9,500
(iii)	Cash Received (3,500 + 1,050)	4,550

(iv)	Total Instalments Due but Unpaid	300
(v)	Total Amount of Instalments not Yet Due	4,650

14.4.1 Ascertainment of Profit: Debtor Method

The profit made by the Vendor on hire-purchase transactions in case of goods of small value, can be ascertained by any of the following methods:

(a) Debtors Method.

(b) Stock and Debtors Method.

(A) Debtors Method

In case of this method, a Hire Purchase Trading Account is prepared to ascertain the amount of profit or loss made on goods sold on hire purchase. The Hire Purchase Trading Account is on the pattern of a Consignment Account or a Branch Account. The following accounting entries are, therefore, also on the same pattern.

(i) *For goods sold (sent) on hire purchase*:
Hire Purchase Trading Account *Dr.*
    To Goods sold on Hire Purchase Account
(at hire purchase price)

(ii) *For cash received from customers*:
Cash Account *Dr.*
    To Hire Purchase Trading Account

(iii) *For instalments due but unpaid at the end of the accounting year*:
Instalments due/Hire Purchase Debtors Account *Dr.*
    To Hire Purchase Trading Account

(iv) *For instalments not yet due at the end of the accounting year*:
Instalments not yet due/Hire Purchase Stock Account *Dr.*
    To Hire Purchase Trading Account

(v) *For ascertaining profit.* Since the goods sold on hire-purchase as well as stock lying with hire purchase customers are being shown at hire purchase price, it will be necessary to make proper adjustments for loading (as is done in case of Branch Account or Consignment Account when goods are sent at invoice price) in the Hire Purchase Trading Account by means of the following entries:

(a) *For loading included in goods sold (sent) on hire purchase*:
Goods sold on Hire Purchase Account *Dr.*
    To Hire Purchase Trading Account

(b) *For loading included in 'stock with the customers' at the end of the accounting year*:
Hire Purchase Trading Account *Dr.*
    To Stock Reserve

Hire Purchase Stock at the end of the accounting year becomes the opening stock of the next accounting year. It will, therefore, be shown on the debit side of the Hire Purchase Trading Account next year. The balance in the stock reserve account carried forward from last year, will be transferred to the Hire Purchase Trading Account by means of the following journal entry:

NOTES

Stock Reserve Account	*Dr.*
To Hire Purchase Trading Account	

(vi) *For transfer of cost of goods sold on hire purchase:*
The balance of the goods sold on hire purchase account represents the cost of goods sold on hire purchase. It will be transferred to the ordinary trading account or the purchases account by means of the following journal entry:

Goods sold on Hire Purchase Account	*Dr.*
To Trading/Purchase Account	

Illustration 14.7: A trader sells 5 transistors, on hire purchase system during the accounting year 2014. From the following details, prepare:

(i) General Trading Account
(ii) Hire Purchase Trading Account and show the total profit made by him during the year.

	₹	
Cost Price	3,000	each
Cash Price	4,000	each
Hire Purchase Price	5,000	each
Cash Down Payment	1,000	each
Balance in 20 instalments of	200	each
Total Instalments Due	60	
Instalments received	55	

The trader is also making cash sales of transistors besides hire purchase sales. Total purchases amounts to ₹ 35,000 and Cash Sales to ₹ 25,000 and Stock of Transistors in the Shop is 5,000.

Solution

It should be noted that in case of Hire Purchase Trading Account, no separate record is maintained of the interest received by the hire vendor. Hence, the information given regarding cash price is superfluous so far as preparation of Hire Purchase Trading Account is concerned.

The following basic calculations are necessary for preparing the Hire Purchase Trading Account:

		Cost Price	*Hire Purchase Price*
(i)	Goods sold on hire purchase	5 × 3,000 = 15,000	5 × 5,000 =25,000
(ii)	Cash received: Cash Down Payment	5 × 1,000 = 5,000	
	Instalment received	55 × 200 = 11,000	
		16,000	
(iii)	Instalments due but unpaid:	5 × 200 = 1,000	
(iv)	Instalments not yet due	40 × 200 = 8,000	
(v)	Adjustment for loading		

(a) *Loading in goods sold on hire purchase*:

Hire Purchase Price	₹ 25,000
Cost Price	₹ 15,000
Loading	₹ 10,000

(b) *Loading in instalments not yet due*:

$$\frac{\text{Instalments Not yet Due}}{\text{Total Hire Purchase Price}} \times \text{Loading included in Goods sold on Hire Purchase}$$

$$= \frac{8,000}{25,000} \times 10,000 = 3,200$$

The Hire Purchase Trading Account can now be prepared as follows:

NOTES

Hire Purchase Trading Account
Dr. for the year ending 31st December, 2014 Cr.

Particulars	₹	*Particulars*	₹
To Goods sold on hire purchase	25,000	By Cash	16,000
To Stock Reserve	3,200	By Instalments due but unpaid	1,000
To Profit transferred to P & L A/c	6,800	By Instalment not yet due	8,000
		By Goods sold on hire purchase	10,000
	35,000		35,000

General Trading and Profit and Loss Account

Particulars		₹	*Particulars*	₹
To Purchases	35,000		By Sales	25,000
Less: Cost of goods sold			By Closing Stock	5,000
on hire purchase	15,000	20,000		
To Gross Profit taken to P & L A/c		10,000		
		30,000		30,000
To Total Profit c/d		16,800	By Gross Profit b/d	10,000
			By Profit on goods sold on hire purchase (transferred from Hire Purchase Trading Account)	6,800
		16,800		16,800

14.4.2 Default and Repossession

In the event of the hire purchaser's failure to pay the instalment on the due date, the hire vendor may seize the goods and forefeit instalments so far paid by him. The following journal entry will be passed in the event of such seizure in the books of the hire vendor.

Goods Repossessed Account *Dr.*
To Hire Purchase Trading Account
(with the true value of the goods repossessed)

The true value of the goods repossessed may be ascertained on the basis of the following formula:

$$\text{Unpaid Amount} \times \frac{\text{Cost Price of the Goods sold on Hire purchase}}{\text{Hire Purchase Price}}$$

For example, if an article whose cost price is ₹ 500, hire purchase price ₹ 800 and instalments unpaid ₹ 400 is repossessed by the vendor, it will be valued as follows:

$$400 \times \frac{500}{800} = ₹\,250$$

NOTES

Tutorial Note

It should be noted that if the Hire Purchase Trading Account is prepared at the hire purchase price (without making adjustments for loading), the two sides of the hire purchase trading account will tally. Thus, any missing information can be found out by preparing a Memorandum Hire Purchase Trading Account. After finding out the missing information, the Hire Purchase Trading Account may be prepared and the profit can be ascertained after making adjustments for loading. The following is the proforma of Memorandum Hire Purchase Trading Account:

Memorandum Hire Purchase Trading Account

Particulars		₹	*Particulars*		₹
To Opening Balances:			By Cash Received	(4)	...
Stock with Customers	(1)	...	By Goods Repossessed	(5)	...
Instalment due	(2)	...	By Closing Balances:		
To Goods sold on hire purchase	(3)	...	Hire Purchase Stock	(6)	...
			Instalments due	(7)	...
		...			...

Items aforementioned in the Hire Purchase Trading Account are maximum possible number of items. They are all to be taken at the hire purchase price. Of course, goods repossessed should be shown at a value which is equivalent to the unpaid instalments in respect of such goods.

Having prepared the Memorandum Hire Purchase Trading Account, profit or loss made on hire purchase can be ascertained either by preparing a Hire Purchase Adjustment Account or by Hire Purchase Trading Account.

Hire Purchase Adjustment Account

The account is similar to Branch Adjustment Account which is prepared to ascertain profit in case of a dependent branch. Its proforma is as follows:

Hire Purchase Adjustment Account

Particulars	₹	*Particulars*	₹
To Stock Reserve (with the amount of loading in closing stock)	...	By Stock Reserve (with the amount of loading in opening stock)	...
To Loss on Goods Repossessed (difference between the amount unpaid and the value of the goods repossessed)	...	By Goods sold on Hire Purchase (with the amount of loading in goods sold on hire purchase)	...
To Profit	...		
	...		...

Hire Purchase Trading Account

Hire Purchase Trading Account may be prepared at the hire purchase price. Adjustments may be made for loading included in (i) Goods sold (sent) on hire purchase and (ii) Stock with the customers both at the beginning and at the end of the accounting period. The Hire Purchase Trading Account will appear as follows:

NOTES

Hire Purchase Trading Account

Particulars	₹	*Particulars*	₹
To Opening Balance:		By Cash received	...
Stock with the Customers	...	By Goods Repossessed (at	
Instalment due	...	realisable value)	...
To Goods Sold (sent) on Hire		By Stock Reserve (loading in	
Purchase	...	opening stock)	...
To Stock Reserve (loading in closing stock)	...	By Goods sold on Hire Purchase (Loading)	...
To Profit transferred to Profit and		By Closing Balances:	
Loss Account*	...	Stock with the Customers	
		Instalments Due	...
		By Loss transferred to Profit and Loss Account*	...
	...		...

*Only one figure will be there.

Illustration 14.8: Rama Bros. have Hire Purchase Department. They sell goods on hire purchase at cost plus 50%. From the following details, you are required to find out the profit made by the Hire Purchase Department.

Date	*Particulars*	₹
Jan. 1	Stock with Hire Purchase Customers at Selling Price	9,000
	Stock at Shop at Cost	18,000
	Instalments Due	5,000
Dec. 31	Cash received from Customers	60,000
	Goods Repossessed (Instalments due ₹ 2,000)	500
	Instalments due (customers paying)	9,000
	Stock at Shop (incl. repossessed goods)	20,500
	Purchases during the year	60,000

Solution

Information about two items has not been given in the question. These items are (i) Goods sold (sent) on hire purchase and (ii) Hire purchase stock with the customers at the end of the accounting period. The value of these two items can be ascertained by preparing (i) Stock at Shop Account and (ii) Memorandum Hire Purchase Trading Account.

Stock at Shop Account

Particulars	₹	*Particulars*	₹
To Balance b/d	18,000	By Goods sold on Hire Purchase	
To Purchases	60,000	(at cost-balancing figure)	58,000
		By Balance c/d (excl. repossessed goods)	20,000
	78,000		78,000

Memorandum Hire Purchase Trading Account

Particulars	₹	*Particulars*	₹
To Opening Balance:		By Cash Received	60,000
Stock with Customers	9,000	By Goods Repossessed	
Instalments Due	5,000	(total instalments unpaid)	2,000

NOTES

Particulars	₹	*Particulars*	₹
To Goods sold on Hire Purchase (₹ 58,000 + ₹ 29,000)	87,000	By Closing Balances: Instalment Due	9,000
		By Stock with Customers (Balancing figure)	30,000
	1,01,000		1,01,000

Having collected the information about the missing items, the profit on hire purchase can be ascertained either by preparing a Hire Purchase Adjustment Account or a Hire Purchase Trading Account.

Hire Purchase Adjustment Account

Particulars	₹	*Particulars*	₹
To Stock Reserve (Loading in Closing Stock)	10,000	By Goods sold on Hire Purchase (Loading)	29,000
To Loss on Goods Repossessed (₹ 2,000 – ₹ 500)	1,500	By Stock Reserve (Loading in Opening Stock)	3,000
To Profit transferred to Profit and Loss Account	20,500		
	32,000		32,000

Hire Purchase Trading Account

Particulars	₹	*Particulars*	₹
To Opening Balances:		By Cash Received	60,000
Stock with Customers	9,000	By Goods Repossessed	
Instalments Due	5,000	(at realisable value)	500
To Goods sold on Hire Purchase	87,000	By Goods sold on Hire Purchase	
To Stock Reserve (loading in		(Loading)	29,000
closing stock)	10,000	By Stock Reserve (loading in	
To Profit transferred to Profit and		opening stock)	3,000
Loss Account	20,500	By Closing Balances:	
		Stock with Customers	30,000
		Instalment Due	9,000
	1,31,500		1,31,500

Goods Sold on Hire Purchase Account

Particulars	₹	*Particulars*	₹
To Hire Purchase Trading Account (loading)	29,000	By Hire Purchase Trading Account	87,000
To Stock at Shop Account (Cost of Goods sold on Hire Purchase)	58,000		
	87,000		87,000

14.4.3 Ascertainment of Profit: Stock and Debtors System

The profit made on hire purchase transactions can also be ascertained according to Stock and Debtors System as is done in the case of Branch Accounts. Separate accounts are opened for Hire Purchase Stock Account, Hire Purchase Debtors Account, Goods sold of Hire Purchase, Hire Purchase Adjustment Account etc.

NOTES

The following are the journal entries to be passed in the books of account if this method is followed:

(i) *For Goods Sold (sent) on Hire Purchase*:
Hire Purchase Stock A/c *Dr.*
To Goods sold on Hire Purchase
(at hire purchase price)

(ii) *For Receiving Cash Down Payments*:
Bank/Cash/A/c *Dr.*
To Hire Purchase Stock A/c

(iii) *For total Instalments Due During the year*:
Hire Purchase Debtors A/c *Dr.*
To Hire Purchase Stock A/c

(iv) *For Onstalments received from the Hire Purchase Customer*:
Bank/Cash A/c *Dr.*
To Hire Purchase Debtors A/c

(v) *For Goods Repossessed*:
Goods Repossessed A/c *Dr.*
(with the amount unpaid)
To Hire Purchase Stock A/c
(with the amount not due)
To Hire Purchase Debtors A/c
(with the amount due)

(vi) *For Loss on Goods Repossessed*:
Hire Purchase Adjustment Account *Dr.*
To Goods Repossessed Account
(with the difference between instalments unpaid and realisable value of the goods repossessed)

(vii) *For Loading in Opening Stock with Customers*:
Hire Purchase Adjustment Account *Dr.*
To Stock Reserve

(viii) *For Loading in Opening Stock with Customers*:
Stock Reserve Account *Dr.*
To Hire Purchase Adjustment Account
(Opening stock of this year must have been the closing stock of the last year and hence stock reserve must have been created last year. This account in now closed by transferring it to Hire Purchase Adjustment Account)

(ix) *For Loading in Goods Sold (sent) on Hire Purchase*:
Goods sold on Hire Purchase *Dr.*
To Hire Purchase Adjustment Account

(x) *For Transfer of Profit on Hire Purchase*:
Hire Purchase Adjustment Account *Dr.*
To Profit and Loss Account
In case of loss, the entry will be reversed

(xi) *For Transfer of Balance of "goods sold on hire purchase account" representing cost of goods sold on hire purchase*:
Goods sold on Hire Purchase Account *Dr.*
To Purchases (or General Trading or Stock at Shop) Account

NOTES

Illustration 14.9: Work out Illustration 14.8 by Stock and Debtors System.

Solution

Hire Purchase Stock Account

Particulars	₹	*Particulars*	₹
To Balance b/d	9,000	By Hire Purchase Debtors Account (Total Instalments due)	66,000
To Goods sold on Hire Purchase Account	87,000	By Balance c/d	30,000
	96,000		96,000

Hire Purchase Debtors (Instalments Due) Account

Particulars	₹	*Particulars*	₹
To Balance b/d	5,000	By Goods Repossessed A/c	2,000
To Hire Purchase Stock Account (Total Instalments Due— Balancing Figure)	66,000	By Cash	60,000
		By Balance c/d	9,000
	71,000		71,000

Goods Sold (Sent) on Hire Purchase

Particulars	₹	*Particulars*	₹
To Stock at Shop Account	58,000	By Hire Purchase Stock Account	87,000
To Hire Purchase Adjustment A/c	29,000		
	87,000		87,000

Goods Repossessed Account

Particulars	₹	*Particulars*	₹
To Hire Purchase Debtors Account	2,000	By Hire Purchase Adjustment Account (Loss)	1,500
		By Balance c/d	500
	2,000		2,000

Stock Reserve Account

Particulars	₹	*Particulars*	₹
To Hire Purchase Adjustment Account (transfer)	3,000	By Balance b/d (Loading in Opening Stock)	3,000
To Balance c/d	10,000	By Hire Purchase Adjustment Account	10,000
	13,000		13,000

Stock at Shop Account

Particulars	₹	*Particulars*	₹
To Balance b/d	18,000	By Goods sold on Hire Purchase (at cost)	58,000
To Purchases	60,000	By Balance c/d (excl. repossessed goods)	20,000
	78,000		78,000

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Hire Purchase Adjustment Account

Particulars	₹	*Particulars*	₹
To Goods Repossessed Account	1,500	By Goods sold on Hire Purchase Account (loading)	29,000
To Stock Reserve Account (Loading in closing stock)	10,000		
To Profit transferred to Profit and Loss Account	20,500	By Stock Reserve (loading in Opening Stock)	3,000
	32,000		32,000

Illustration 14.10: Delhi Television House sells goods both on cash and hire purchase basis and records hire purchase transactions on Stock and Debtors system, and closes its books on December 31, every year.

On 1.4.2014, it sold to Rajan a colour *TV* set and *DVD*. The other particulars are as follows:

Items	*TV Set*	*DVD*
Cost Price	₹ 9,000	₹ 16,000
Down Payment	2,000	4,000
No. of Instalments Payable	10	8

Items	*TV Set*	*DVD*
Amount in each Instalment	1,000	2,000
Mode of Payment	Monthly	Bi-Monthly
First Instalment Due on	1.5.2014	1.6.2014

Rajan paid all the instalments due except for those due on December 1, 2008. It was decided that Television House will take back *DVD* at an agreed price of ₹ 11,000 and excess amount, if any will be adjusted against the instalments due on TV set.

DVD repossessed was sold for ₹ 12,000 after repair; charges for which amounted to ₹ 500 only.

Prepare necessary ledger accounts to record the above transactions and find out the profit.

(*B.Com, Hons Delhi, adapted*)

Solution

Hire Purchase Stock Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.4.14	To Goods sold on Hire Purchase A/c	32,000	Dec. 1	By Goods Repossessed A/c	8,000
				By Hire Purchase Stock A/c	22,000
				By Balance c/d	2,000
		32,000			32,000

Hire Purchase Adjustment Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
	To Stock Reserve A/c	500	1.4.14	By Goods sold on Hire Purchase A/c	7,000
	To Profit and Loss A/c	6,500			
		7,000			7,000

NOTES

Hire Purchase Debtors Account

Date	Particulars	₹	Date	Particulars	₹
1.12.14	To Hire Purchase Stock A/c	22,000	1.4.14	By Cash	6,000
				By Cash (instalments received)	13,000
				By Goods Repossessed A/c	3,000
		22,000			22,000

Goods Repossessed Account

Date	Particulars	₹	Date	Particulars	₹
1.12.14	To Hire Purchase Stock A/c	8,000		By Bank	12,000
	To Hire Purchase Debtors A/c	3,000			
	To Bank A/c	500			
	To Profit & Loss A/c	500			
		12,000			12,000

Profit and Loss Account (Extracts)

Date	Particulars	₹	Date	Particulars	₹
				By Goods Repossessed A/c	500
				By Hire Purchase Adjustment A/c	6,500
					7,000

Goods Sold on Hire Purchase Account

Date	Particulars	₹	Date	Particulars	₹
	To Hire Purchase Adjustment A/c	7,000	1.4.14	By Hire Purchase Stock A/c	32,000
	To Trading A/c	25,000			
		32,000			32,000

Working Notes:

1. **Computation of Instalment Received, due etc.**

Item	Cash Price	Hire Purchase Price	Cash Down	Instalments			
				Number	Received	Due but not received	Not due
1	2	3	4	5(a)	5(b)	5(c)	5(d)
TV	9,000	12,000	2,000	10 @ 1,000	7	1	2
DVD	16,000	20,000	4,000	8 @ 2,000	3	1	4

2. Entry for goods repossessed

Goods Repossessed A/c	*Dr.*	11,000	
To Hire Purchase Stock Account			8,000
To Hire Purchase Debtors A/c (2,000 + 1,000)			3,000

Check Your Progress

6. In which method of ascertainment of profit is a Hire Purchase Trading Account prepared?
7. State the formula for the true value of goods repossessed.

14.5 HIRE PURCHASE AND INSTALMENT

The instalment purchase system is also termed a Deferred Instalment System. In case of this system, there is an outright sale of goods with the buyer having the facility to pay the purchase price in certain number of agreed instalments. Thus, the instalment price includes both the cash price as well as the interest for delayed payment. The possession and legal ownership of the goods passes to the buyer immediately.

The following are the essential characteristics on this system:

(i) The buyer gets immediate possession and ownership of the goods.

(ii) The payment of price has to be made by the buyer in agreed instalments.

(iii) In the event of default by the buyer in payment of any instalment, the seller can bring a suit against the buyer for recovery of unpaid price and damages. In no case he can recover back the goods.

The Instalment Purchase System of selling goods can be employed for similar goods which are suitable for sale under hire purchase system. The seller has also to be cautious in the selection of the customers.

14.5.1 Difference between Hire Purchase System and Instalments Purchase System

The following are the points of difference between the two systems:

From Legal Viewpoint

1. ***Transfer of ownership:*** In case of hire purchase system the ownership in the goods sold passes to the buyer only on payment of the last instalment. While in case of deferred instalment system, the ownership in the goods passes to the buyer immediately at the time of sale.
2. ***Recovery of goods:*** In case of hire purchase system, if the buyer fails to pay any instalment, the seller can recover the goods back from buyer. While in case of deferred instalment system, the seller cannot recover the goods. He can only sue for recovery of price and damages.
3. ***Forfeiture of instalments paid:*** In case of hire purchase system in the event of buyer's default in payment, the seller can forfeit all the money paid by the buyer so far, while in case of instalment system,

NOTES

the money paid by the buyer will be taken as a payment towards part of the selling price and the seller can sue only for the balance.

From Accounting Viewpoint

1. ***Charging of interest:*** In case of hire purchase, the buyer is initially charged with the cash price and periodically with interest on the outstanding cash price. However, in case of instalment system the buyer is charged with full instalment price including total interest.
2. ***Computation of loss on seizure of goods by the vendor:*** In case of hire purchase, in the event of seizure of goods by the vendor, due to buyer's default, the loss on seizure of goods has to be computed. However, in case of instalment system, the vendor cannot seize the goods and hence the need for computation of loss on seizure does not arise.

Accounting Entries

Accounting entries to be made in respect of purchase and sale of goods under Instalment System are similar to those under the Hire Purchase System (1st method explained and illustrated in the preceding pages). However, there are two minor differences:

(i) The Purchaser in the books of the Vendor is debited with full Purchase Price as soon as the contract is signed. Similarly the Vendor is credited with the full Purchase Price in the books of the Purchaser. The amount of interest is put to a separate account termed as "Interest Suspense Account". The interest relating to each year on the outstanding balance is transferred from the Interest Suspense Account to the Interest Account which is ultimately transferred to the Profit and Loss Account.

(ii) The goods purchased become property of the buyer and hence they are shown in his Balance Sheet at cost less Depreciation. The amount due to the Vendor is shown separately as a Liability and not as a deduction from the Asset.

The Accounting Entries to be made in case of Instalment System can be well understood with the help of the following illustration.

Illustration 14.11: *A* purchased on instalment basis a machinery from *B* on 1st January, 2013 for a sum of ₹ 80,000, ₹ 20,000 is to be paid on the signing of the contract and rest in three instalments of ₹ 20,000 each. The cash price of the machine is ₹ 74,500 and interest is charged by the vendor at 5% p.a. The buyer charges depreciation at 10% p.a. on the diminishing balance. You are required to pass the necessary journal entries in the books of both the buyer and the vendor and show how the different items will appear in the Balance Sheet of *A* on 31st December, 2013.

Solution

A's Journal

Date	*Particulars*		(₹)	(₹)
2013	Machinery Account	*Dr.*	74,500	
Jan. 1	Interest Suspense Account	*Dr.*	5,500	
	To *B*			80,000
	(*For purchase of machinery on instalment system*)			
Jan. 1	*B*	*Dr.*	20,000	
	To Bank			20,000
	(*Cash down Payment*)			
Dec. 31	Interest Account	*Dr.*	2,725	
	To Interest Suspense Account			2,725
	(*Interest for 2013*)			
Dec. 31	*B*	*Dr.*	20,000	
	To Bank			20,000
	(*Payment of Instalment*)			
Dec. 31	Depreciation Account	*Dr.*	7,450	
	To Machine Account			7,450
	(*Depreciation for the year*)			
2014	Interest Account	*Dr.*	1,861	
Dec. 31	To Interest Suspense Account			1,861
	(*Interest for 2014*)			
Dec. 31	*B*	*Dr.*	20,000	
	To Bank			20,000
	(*Instalment paid*)			
Dec. 31	Depreciation Account	*Dr.*	6,705	
	To Machine Account			6,705
	(*Depreciation for the year*)			
2015	Interest Account	*Dr.*	914	
Dec. 31	To Interest Suspense Account			914
	(*Interest for 2015*)			
Dec. 31	*B*	*Dr.*	20,000	
	To Bank			20,000
	(*Instalment paid*)			
Dec. 31	Depreciation Account	*Dr.*	6,035	
	To Machine Account			6,035
	(*Depreciation for the year*)			

NOTES

Balance Sheet (Extracts)
as on 31.12.2013

Liabilities	₹	*Assets*		₹
Creditor for Machinery (B)	40,000	Machinery (at cost)	74,500	
Interest Suspense Account	2,775	*Less:* Depreciation	7,450	67,050
(5,500 – 2,725)				
		Profit and Loss Account		2,725
		(Interest for 2013)		

NOTES

B's Journal

Date	*Particulars*	(₹) *Dr*	(₹) *Cr*
2013	*A* *Dr.*	80,000	
Jan. 1	To Sales Account		74,500
	To Interest Suspense Account		5,500
	(*Sale of Machinery on Instalment System*)		
Jan. 1	Bank Account *Dr.*	20,000	
	To *A*		20,000
	(*Cash Down Payment recd.*)		
Dec. 31	Interest Suspense Account *Dr.*	2,725	
	To Interest Account		2,725
	(*Interest for 2013*)		
Dec. 31	Bank Account *Dr.*	20,000	
	To *A*		20,000
	(*Instalment recd.*)		
2014	Interest Suspense Account *Dr.*	1,861	
Dec. 31	To Interest Account		1,861
	(*Interest for 2014*)		
Dec. 31	Bank Account *Dr.*	20,000	
	To *A*		20,000
	(*Instalment recd.*)		
2015	Interest Suspense Account *Dr.*	914	
Dec. 31	To Interest		914
	(*Interest for 2015*)		
Dec. 31	Bank Account *Dr.*	20,000	
	To *A*		20,000
	(*Instalment received*)		

Working Notes:

The interest included in each instalment has been ascertained by preparing Memorandum Account of *B* in *A*'s Books.

B's Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
Jan. 1	To Bank	20,000	Jan. 1	By Machinery Account	74,500
Dec. 31	To Bank	20,000	Dec. 31	By Interest	
	To Balance c/d	37,225		(at 5% on 54,000)	2,725
		77,225			77,225
2014			2014		
Dec. 31	To Bank	20,000	Jan. 1	By Balance b/d	37,225
	To Balance c/d	19,086	Dec. 31	By Interest	1,861
		39,086			39,086
2015			2015		
Dec. 31	To Bank	20,000	Jan. 1	By Balance b/d	19,086
			Dec. 31	By Interest	914
		20,000			20,000

Interest Suspense Method in Case of Hire Purchase

The Interest Suspense Method which is followed in case of Instalment Payment System may also be followed in case of Hire Purchase transactions.

This method is adopted by firms having a large number of hire purchase sales transactions with instalments extending over a fixed period. In case of this method, the total hire purchase charges are credited by the Vendor to a separate Interest Suspense Account by means of the following entry:

Hire Purchaser Account *Dr.*
(with hire purchase price)
To Hire Purchase Account
(with cash price)
To Interest Suspense Account

Separate sales books are maintained for recording sales of each different duration, say goods sold for monthly instalments, quarterly instalments, etc. Hence, there may be more than one Interest Suspense Account.

The hire purchase charges credited to the Interest Suspense Account are allocated to Trading Account/Profit & Loss Account proportionately over the length of the instalment period by means of the following journal entry:

Interest Suspense Account *Dr.*
To Trading/Profit & Loss Account
(with the amount of proportionate interest)

Illustration 14.12: Buyers Ltd. purchased a Car on 1st January, 2014 on Hire Purchase basis from Vendors Ltd. The cash down price was ₹ 30,000. The terms of purchase were as under:

(i) ₹ 12,000 is payable as deposit.

(ii) Balance being payable by 12 quarterly instalments of ₹ 1,920 each, falling due from 1st April, 2014.

The financial year of Buyers Ltd. ends on 30th June.

On 30th September 2015, the Car was sold for ₹ 20,000 and the Hire Purchase balance were settled for ₹ 10,200.

Buyers Ltd. brings the asset account at cash price and spreads the interest equally over the period of Hire Purchase payments. Depreciation at 20 per cent per annum on cost was provided up to the date of sale.

Show the Car Account, Vendors Ltd. Account, and Interest Suspense Account in the books of Buyers Ltd.

Solution

LEDGER OF BUYERS LTD.

Truck Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
Jan. 1	To Vendor Ltd.	30,000	June 30	By Depreciation @ 20% p.a)	3,000
				By Balance c/d	27,000
		30,000			30,000
2014			2014		
July 1	To Balance c/d	27,000	June 30	By Depreciation	6,000
				By Balance c/d	21,000

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Date	Particulars	₹	Date	Particulars	₹
		27,000			27,000
2015			2015		
July 1	To Balanced b/d	21,000	Sept. 30	By Depreciation (for 3 months)	1,500
	To Profit & Loss Ac-count			By Bank (sale proceeds)	20,000
	(Profit on sale)	500			
		21,500			21,500

Vendors Ltd.

Date	Particulars	₹	Date	Particulars	₹
2014			2000		
Jan. 1	To Bank	12,000	Jan. 1	By Car A/c	30,000
April 1	To Bank	1,920		By Interest Suspense A/c	5,040
June 30	To Balanced c/d	21,120			
		35,040			35,040
2014			2000		
July 1	To Bank	1,920	July 1	By Balanced b/d	21,120
Oct. 1	To Bank	1,920			
2015					
Jan. 1	To Bank	1,920			
April 1	To Bank	1,920			
June 30	To Balanced c/d	13,440			
		21,120			21,120
2015			2015		
July 1	To Bank	1,920	July 1	By Balanced b/d	13,440
Sept. 30	To Bank	10,200			
	To Interest Susp. A/c	1,320			
		13,440			13,440

Interest Suspense Account

Date	Particulars	₹	Date	Particulars	₹
2014			2014		
Jan. 1	To Vendors Ltd.	5,040	June 30	By Profit & Loss A/c	
				(2/12 of 5,040)	840
				By Balance c/d	4,200
		5,040			5,040
2014			2015		
July 1	To Balanced b/d	4,200	June 30	By Profit & Loss A/c	
				(4/12 of 5,040)	1,680
				By Balance c/d	2,520
		4,200			4,200
2001			2015		
July 1	To Balanced b/d	2,520	Sept. 30	By Vendors Ltd.	1,320
			2007		
			June 30	By Profit & Loss A/c	
				(Balancing figure)	1,200
		2,520			2,520

Working Note:

		₹
Interest Suspense:	Down Payment	12,000
	Instalment: 12 @ ₹ 1,920 each	23,040
		35,040
	Cash Price	30,000
	Interest Suspense	5,040

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Check Your Progress

8. What constitutes the instalment price in the case of instalment purchase system?
9. State the difference in the charging of interest in the case of hire purchase system and instalments purchase system.due.

14.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The terms used for the difference between the hire purchase price and the cash price is known hire purchase prices, finance charges or simply interest.
2. An example of termination of hire purchase agreement by supervening impossibility is if the goods are destroyed during the currency of hire purchase agreement without negligence on the part of the hirer resulting in the end of the agreement.
3. In case the rate of interest is not given in case of goods of substantial sales value, the interest is calculated on the basis of hire purchase price outstanding in the beginning of each year.
4. The journal entry to be passes in the books of the hire vendor in case of interest due is:

   Hire Purchaser Account Dr.

   To Interest Account
5. The journal entry in the books of hire vendor in case of selling of goods repossessed is:

   Cash/Bank Dr.

   To Goods Repossessed Account
6. In case of Debtors method, a Hire Purchase Trading Account is prepared to ascertain the amount of profit or loss made on goods sold on hire purchase.
7. The formula for ascertaining the true value of the goods repossessed is:

   Cost price of the Goods sold on Hire purchase divided by the hire purchase price multiplied by the unpaid amount.

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8. The instalment price constitutes both the cash price as well as the interest for delayed payment.
9. Charging of interest in case of hire purchase involves the buyer being initially charged with the cash price and periodically with interest on outstanding cash price. However, in case of instalment system, the buyer is charged with full instalment price including total interest.

14.7 SUMMARY

- A contract of hire purchase is a contract where goods are purchased or sold with the stipulations that: the delivery of goods will be given by the owner of the goods to the hire purchaser, the payment of the price for the goods will be made in instalments, the ownership of the goods passes to the hire purchaser only on payment of all the instalments and that in the event of hire purchaser's failure to pay any instalment, the hire vendor will be entitled to seize the goods and adjust the money paid.
- A bailment is the delivery of goods by one person to another for some purpose, under the contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the persons delivering them.
- A hire purchase agreement is a form of bailment in which the hirer is given the right to purchase only on certain terms and conditions.
- A hire purchase agreement can be terminated by agreement, performance, renewal, acceptance of repudiation by other party, release, supervening impossibility and efflux of time.
- In case of hire purchase transactions relating to goods of substantial sales value, a proper distinction has to be made between: (i) Cash Price of the Goods and (ii) Hire purchase charges, which are generally categorized as Interest.
- When cash price, rate of interest, hire purchase price and number of instalments etc. are all given, the interest is to be calculated on the outstanding balance of the cash price at the stipulated rate. If the rate of interest is not given, the interest included in each instalment will be calculated on the basis of hire purchase price outstanding in the beginning of each year.
- There are two methods for making accounting entries of the hire purchase transactions in the books of the hire purchaser: (i) when asset is recorded at full cash price; and when asset is recorded at the cash price actually paid.
- In case the hire purchaser fails to make payment of any instalment, the hire vendor may seize the goods and forfeit all amounts paid by the hire

purchaser so far. Seizure of the goods may be partial or full depending on the circumstances and the agreement between the parties.

- In cases where goods sold on hire purchase are of small sales values, the transactions are numerous and the parties of agreement may vary, the vendor in such cases generally maintains a Memorandum record of the hire purchase transactions in a hire purchase sales register with appropriate columns.
- The profit made by the Vendor on hire-purchase transactions in case of goods of small value, can be ascertained by the Debtors or Stock and Debtors method.
- In a lease transaction, there are two important rights to the property are differentiated, namely (i) right to own and (ii) right to use. The Institute of Chartered Accountants of India issues AS 19, dealing with accounting for leases.
- In the instalment purchase or deferred instalment system, there is an outright sale of goods with the buyer having the facility to pay the purchase price in certain number of agreed instalments.

14.8 KEY WORDS

- **Cash price:** It is the price at which the goods may be purchased by the hirer for cash.
- **Finance lease:** It is a lease agreement under which the present value of minimum lease payments at the inception of the lease exceeds or is substantially equal to the whole of the fair value of the leased asset.
- **Hire purchase contract:** It refers to a contract where the goods are sold by one person to another with stipulations including price paid in agreed instalments; transfer of ownership after the payment of last instalment; and in the event of failure of the buyer to pay any instalment, the entitlement to seize the goods and forfeit the entire amount.
- **Hire purchase charges:** It is the difference the hire purchase price and the cash price.
- **Hirer:** It refers to a person who obtains or has obtained possession of goods from an owner under hire purchase agreement.
- **Instalment purchase contract:** It is a contract where goods are sold by one person to another with stipulations including: the prices paid in agreed instalments; the buyer gets immediate possession and ownership of goods; in the event of buyer's failure to pay any instalment the seller may file a suit for recovery of price and damages and not for repossession of goods.

- **Lease:** It is an agreement whereby the lessor converys to the lessee, in return for rent, the right to use an asset for an agreed period of time.
- **Operating lease:** It is a lease other than a finance lease.

NOTES

14.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What is meant by Hire Purchase System ?
2. How does hire purchase system differ from Instalment System?
3. Differentiate between Finance lease and Operating lease.
4. What do you understand by 'Sales and Lease Back'?
5. State any four situations when a lease would be classified as Finance Lease.

Long-Answer Questions

1. Point out the difference between the Hire Purchase System and Instalment Purchase System from:
   (i) the legal point of view, and
   (ii) the accounting point of view.
2. Define Leasing. Explain different types of lease agreements. Compare leasing with hire purchase.
3. What is Hire-Purchase Trading Account? How is it prepared?

14.10 FURTHER READING

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