ALAGAPPA UNIVERSITY

[Accredited with 'A+' Grade by NAAC (CGPA:3.64) in the Third Cycle
and Graded as Category–I University by MHRD-UGC]

(A State University Established by the Government of Tamil Nadu)

KARAIKUDI – 630 003

Directorate of Distance Education

B.Com.

I - Semester

102 14

FINANCIAL ACCOUNTING

Reviewer	
Dr. R. Ganapathi	Assistant Professor, Directorate of Distance Education, Alagappa University, Karaikudi

Authors:

Dr. S.N. Maheshwari, *Professor Emeritus and Academic Advisor Delhi Institute of Advanced Studies, Delhi*
Dr. Suneel K. Maheshwari, *Professor of Accounting, Eberly College of Business and Information Technology, Indiana University of Pennsylvania, USA*
CA Sharad K. Maheshwari, *Maheshwari Sharad & Co. Chartered Accountants, Gurugram, Haryana*

VIKAS® PUBLISHING HOUSE PVT. LTD.
E-28, Sector-8, Noida - 201301 (UP)
Phone: 0120-4078900 • Fax: 0120-4078999
Regd. Office: 7361, Ravindra Mansion, Ram Nagar, New Delhi 110 055
• Website: www.vikaspublishing.com • Email: helpline@vikaspublishing.com

Work Order No. AU/DDE/DE1-238/Preparation and Printing of Course Materials/2018 Dated 30.08.2018 Copies - 500

SYLLABI-BOOK MAPPING TABLE

Financial Accounting

Syllabi	Mapping in Book
BLOCK I: BASIC FINANCIAL ACCOUNTING AND CONCEPTS **UNIT – I:** Financial Accounting – Meaning of Book Keeping, Accounting and Accountancy - Distinction between Book Keeping and Accounting, Accounting Process - Objectives of Accounting - Various users of Accounting Information, Limitations of Accounting - Accounting Terminologies. **UNIT – II:** Accounting Concepts - Principles and Conventions – Meaning of Accounting Concepts – Principles – Conventions - Types of Accounting Concepts - Types of Accounting Principles - Types of Accounting Conventions - Accounting standards - International Financial Reporting Standards [IFRS]. **UNIT – III:** Recording of Transactions - Meaning of Assets – Liabilities – Equity - Accounting Equation and Effects of Financial Transaction on Accounting Equation - Classification of Accounts under Modern Approach Method - Double Entry System and Rules of Debit and Credit Entries. **UNIT – IV:** Secondary Books – Cash Book - Petty Cash Book - Ledger.	**Unit 1:** Basic Concepts of Financial Accounting **(Pages 1-20)** **Unit 2:** Accounting Concepts: Principles and Conventions **(Pages 21-39)** **Unit 3:** Recording of Transactions **(Pages 40-56)** **Unit 4:** Secondary Books (Subsidiary Books) **(Pages 57-88)**
BLOCK II: FINAL ACCOUNTS AND ADJUSTMENTS **UNIT – V:** Trial Balance and Rectification of Errors - Error in Accounting. **UNIT – VI:** Final Accounts – 1 – Meaning - Objectives and Characteristics of Final Accounts - Adjustments before Preparing Final Accounts - Closing Entries. **UNIT – VII:** Final Accounts – 2 – Trading Account - Profit and Loss Account - Balance Sheet - Treatment of Adjustments - Practical Problems. **UNIT – VIII:** Bank Reconciliation Statement - Meaning of Bank Reconciliation Statement - Importance of Bank Reconciliation Statement - Reasons for Difference - Procedure for Reconciliation.	**Unit 5:** Trial Balance and Rectification of Errors **(Pages 89-111)** **Unit 6:** Final Accounts- I **(Pages 112-139)** **Unit 7:** Final Accounts- II **(Pages 140-174)** **Unit 8:** Bank Reconciliation Statement **(Pages 175-190)**
BLOCK III: PARTNERSHIP ACCOUNTS **UNIT – IX:** Bills of Exchange - Acceptance of a Bill - Due Date - Recording of Bill of Exchange in the books of Accounts. **UNIT – X:** Partnership Accounts - Admission of a Partner - Partnership - Meaning and Features - Partnership Deed and Contents - Admission of a Partner - Good will-Meaning - Accounting Treatment of Goodwill at the Time of Admission - Revaluation of Assets and Liabilities - Adjustments of Reserves and Accumulated Profits or Losses.	**Unit 9:** Bills of Exchange **(Pages 191-210)** **Unit 10:** Partnership Accounts **(Pages 211-234)** **Unit 11:** Retirement and Death of a Partner **(Pages 235-254)**

UNIT – XI: Retirement and Death of a Partner – Meaning of Retirement of Partner - Calculation of New Profit Sharing Ratio and Gaining Ratio - Adjustments with Regard to Goodwill - Revaluation of Assets and Liabilities - Settling the Claim of Retiring Partner - Death of Partner.

BLOCK IV: COMPANY ACCOUNTS

UNIT – XII: Depreciation Accounting: Meaning of Depreciation - Causes for Depreciation, Need for Depreciation - Computation of the Amount of Depreciation - Depreciation on Additions to Fixed Assets - Methods of Depreciation, Revised AS 6.

UNIT – XIII: Company Accounts – Kinds of Companies - Formation of Companies - Share Capital - Issue of Shares - Under Subscription & Oversubscription - Issue of Shares at Premium & Discount - Buyback of Shares and Treasury Stock - Accounting Treatments and Ledger Preparation.

UNIT – XIV: Company Accounts – Forfeiture of Shares - Reissue of Shares - Issue of Bonus Shares - Rights Issue - Share Split - Buy Back of Shares - Redemption of Preference Shares - Debentures.

Unit 12: Depreciation Accounting
(Pages 255-280)
Unit 13: Company Accounts-I
(Pages 281-320)
Unit 14: Company Accounts-II
(Pages 321-354)

CONTENTS

INTRODUCTION

BLOCK I: BASIC FINANCIAL ACCOUNTING AND CONCEPTS

UNIT 1 BASIC CONCEPTS OF FINANCIAL ACCOUNTING 1-20

1.0 Introduction
1.1 Objectives
1.2 Meaning of Book-Keeping and Accounting and Distinction Between Them
 1.2.1 Accounting and Accountancy
 1.2.2 Various Users of Accounting Information
 1.2.3 Objectives of Accounting
 1.2.4 Limitations of Accounting
1.3 Accounting system and Process
 1.3.1 Accounting Equation
 1.3.2 Double Entry System and Single Entry System
 1.3.3 Systems of Accounting
1.4 Accounting Terminologies
1.5 Answers to Check Your Progress Questions
1.6 Summary
1.7 Key Words
1.8 Self Assessment Questions and Exercises
1.9 Further Readings

UNIT 2 ACCOUNTING CONCEPTS: PRINCIPLES AND CONVENTIONS 21-39

2.0 Introduction
2.1 Objectives
2.2 Meaning and Types of Accounting Concepts
2.3 Accounting Convention and Its Types
2.4 Accounting Principles
2.5 Accounting Standards
 2.5.1 International Accounting Standards Committee and IAS/IFRS
2.6 Answers to Check Your Progress Questions
2.7 Summary
2.8 Key Words
2.9 Self Assessment Questions and Exercises
2.10 Further Readings

UNIT 3 RECORDING OF TRANSACTIONS 40-56

3.0 Introduction
3.1 Objectives
3.2 Meaning of Assets, Liabilities and Equity, and Modern Approach to Classify Accounts
 3.2.1 Classification of Accounts under Modern Approach Method
3.3 Journal
 3.3.1 Rules of Debit and Credit

3.3.2 Compound Journal Entry
3.3.3 Opening Entry
3.4 Answers to Check Your Progress Questions
3.5 Summary
3.6 Key Words
3.7 Self Assessment Questions and Exercises
3.8 Further Readings

UNIT 4 SECONDARY BOOKS (SUBSIDIARY BOOKS) 57-88

4.0 Introduction
4.1 Objectives
4.2 Different Types of Journals
4.3 Ledger
4.4 Answers to Check Your Progress Questions
4.5 Summary
4.6 Key Words
4.7 Self Assessment Questions and Exercises
4.8 Further Readings

BLOCK II: FINAL ACCOUNTS AND ADJUSTMENTS

UNIT 5 TRIAL BALANCE AND RECTIFICATION OF ERRORS 89-111

5.0 Introduction
5.1 Objectives
5.2 Trial Balance
5.3 Errors in Accounting and Its Rectification
5.3.1 Location of Errors
5.3.2 Rectifying Accounting Entries
5.4 Answers to Check Your Progress Questions
5.5 Summary
5.6 Key words
5.7 Self Assessment Questions and Exercises
5.8 Further Readings

UNIT 6 FINAL ACCOUNTS- I 112-139

6.0 Introduction
6.1 Objectives
6.2 Meaning, Objectives and Characteristics of Final Accounts
6.2.1 Characteristics of Final Accounts
6.2.2 Objectives of Final Accounts
6.3 Adjustments Before Preparing Final Accounts
6.4 Answers to Check Your Progress Questions
6.5 Summary
6.6 Key Words
6.7 Self Assessment Questions and Exercises
6.8 Further Readings

UNIT 7 FINAL ACCOUNTS- II **140-174**
7.0 Introduction
7.1 Objectives
7.2 Trading Account
7.3 Profit and Loss Account
7.4 Balance Sheet
7.4.1 Treatment of Adjustments
7.5 Practical Problems
7.6 Answers to Check Your Progress Questions
7.7 Summary
7.8 Key Words
7.9 Self Assessment Questions and Exercises
7.10 Further Readings

UNIT 8 BANK RECONCILIATION STATEMENT **175-190**
8.0 Introduction
8.1 Objectives
8.2 Meaning, Importance and Procedure of Reconciliation
8.2.1 Reasons for Difference
8.2.2 Meaning and Importance of Bank Reconciliation Statement
8.2.3 Technique or Procedure of Preparing Bank Reconciliation Statement
8.3 Answers to Check Your Progress Questions
8.4 Summary
8.5 Key Words
8.6 Self Assessment Questions and Exercises
8.7 Further Readings

BLOCK III: PARTNERSHIP ACCOUNTS
UNIT 9 BILLS OF EXCHANGE **191-210**
9.0 Introduction
9.1 Objectives
9.2 Bills of Exchange: Fundamental Concepts
9.3 Recording of Bill of Exchange in the Books of Account
9.4 Answers to Check Your Progress Questions
9.5 Summary
9.6 Key Words
9.7 Self Assessment Questions and Exercises
9.8 Further Readings

UNIT 10 PARTNERSHIP ACCOUNTS **211-234**
10.0 Introduction
10.1 Objectives
10.2 Partnership: Meaning, Features, Deed and Contents
10.3 Admission of a Partner
10.4 Answers to Check Your Progress Questions
10.5 Summary

10.6 Key Words
10.7 Self Assessment Questions and Exercises
10.8 Further Readings

UNIT 11 RETIREMENT AND DEATH OF A PARTNER **235-254**

11.0 Introduction
11.1 Objectives
11.2 Retirement of a Partner
11.3 Death of a Partner
11.4 Answers to Check Your Progress Questions
11.5 Summary
11.6 Key Words
11.7 Self Assessment Questions and Exercises
11.8 Further Readings

BLOCK IV: COMPANY ACCOUNTS

UNIT 12 DEPRECIATION ACCOUNTING **255-280**

12.0 Introduction
12.1 Objectives
12.2 Depreciation: Meaning, Need and Cause
- 12.2.1 Causes of Depreciation
- 12.2.2 Basic Features of Depreciation
- 12.2.3 Meaning of Depreciation Accounting
- 12.2.4 Objectives of Providing Depreciation
- 12.2.5 Fixation of Depreciation Amount
- 12.2.6 Methods of Recording Depreciation

12.3 Methods for Providing Depreciation
12.4 Answers to Check Your Progress Questions
12.5 Summary
12.6 Key Words
12.7 Self Assessment Questions and Exercises
12.8 Further Readings

UNIT 13 COMPANY ACCOUNTS-I **281-320**

13.0 Introduction
13.1 Objectives
13.2 Meaning and Characteristics of Companies
13.3 Kinds of Companies
13.4 Formation of Companies
13.5 Share Capital
13.6 Undersubscription, Oversubscription and Issue of Shares at Premium and Discount
13.7 Buyback of Shares and Treasury Stock
13.8 Answers to Check Your Progress Questions
13.9 Summary
13.10 Key Words
13.11 Self Assessment Questions and Exercises
13.12 Further Readings

UNIT 14 COMPANY ACCOUNTS-II **321-354**

14.0 Introduction
14.1 Objectives
14.2 Forfeiture of Shares
14.3 Redemption of Preference Shares
14.4 Right Issue
14.5 Debentures
14.6 Answers to Check Your Progress Questions
14.7 Summary
14.8 Key Words
14.9 Self Assessment Questions and Exercises
14.10 Further Readings

INTRODUCTION

NOTES

Good accountants make good finance managers. This is wholly true since accounting is one of the 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.

Keeping in mind the requirement of financial accounting, we will discuss in this book, the basic financial accounting concepts, the accounting entries related to final accounts and adjustments, the accounting treatment of partnership accounts and the provisions related to maintaining company accounts.

This book, *Financial Accounting*, is written with the distance learning student in mind. It is presented in a user-friendly format using a clear, lucid language. Each unit contains an Introduction and a list of Objectives to prepare the student for what to expect in the text. At the end of each unit are a Summary and a list of Key Words, to aid in recollection of concepts learnt. All units contain Self Assessment Questions and Exercises, and strategically placed Check Your Progress questions so the student can keep track of what has been discussed.

BLOCK - I

BASIC FINANCIAL ACCOUNTING AND CONCEPTS

UNIT 1 BASIC CONCEPTS OF FINANCIAL ACCOUNTING

Structure

1.0 Introduction
1.1 Objectives
1.2 Meaning of Book-Keeping and Accounting and Distinction Between Them
  1.2.1 Accounting and Accountancy
  1.2.2 Various Users of Accounting Information
  1.2.3 Objectives of Accounting
  1.2.4 Limitations of Accounting
1.3 Accounting system and Process
  1.3.1 Accounting Equation
  1.3.2 Double Entry System and Single Entry System
  1.3.3 Systems of Accounting
1.4 Accounting Terminologies
1.5 Answers to Check Your Progress Questions
1.6 Summary
1.7 Key Words
1.8 Self Assessment Questions and Exercises
1.9 Further Readings

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.

NOTES

(*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.

1.1 OBJECTIVES

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

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

1.2 MEANING OF BOOK-KEEPING AND ACCOUNTING AND DISTINCTION BETWEEN THEM

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.

NOTES

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.

NOTES

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 Objectives of Accounting

The following are the main objectives of accounting:

1. **To keep 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. **To protect 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. **To ascertain 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

NOTES

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. **To ascertain 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. **To facilitate 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

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 SYSTEM AND PROCESS

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:

$$\text{Assets} = \text{Equities}$$

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:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

$$\text{or} \quad \text{Capital} = \text{Assets} - \text{Liabilities}$$

NOTES

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

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.

NOTES

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
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

No.	Transaction	Assets	=	Liabilities	+	Capital
	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

NOTES

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 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 TERMINOLOGIES

It will be appropriate to get familiarised with certain basic terms which are used in accounting before proceeding with the technique of recording of business transactions. It is necessary for the readers to go through these basic terms and understand them clearly, since it will be then convenient for them to understand clearly the contents of the chapters which are to follow:

1. **Assets** The terms 'assets' include the resources acquired by a business from the funds made available either by the owners or by others. They are "tangible objects or intangible rights owned by an enterprise and carrying

NOTES

probable future benefits"[1] In other words, property of all kinds owned by a business comes within the category of the term 'assets'.

Assets may be classified into the following categories:

(*i*) *Fixed assets* These are assets which are acquired for relatively long period for carrying on the business of the enterprise. They are not meant for resale. The examples of such assets are land, buildings, plant, machinery, etc.

(*ii*) *Current assets* These are assets which are acquired with the intention of converting them into cash during the normal business operations of the company. They include "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"[2] The essential difference between current assets and fixed assets is that the current assets are held essentially for a short period and they are meant for converting into cash. Examples of such assets are cash, inventories (*i.e.*, stocks of raw material, work-in-progress and finished goods), bills receivable, debtors, etc. These assets are also termed as 'Floating' or 'Circulating' Assets.

(*iii*) *Liquid assets* These are assets which are immediately convertible into cash without much loss. As a matter of fact, all current assets excluding prepaid expenses and inventories are included in the definition of liquid assets.

(*iv*) *Fictitious assets* These are assets which have no real value but are shown in the books of accounts only for technical reasons. Examples of such assets are preliminary expenses incurred in connection with the establishment of a business or discount allowed on issue of shares by a company, etc.

(*v*) *Wasting assets* These are the assets which are exhausted with, or which lose themselves in the goods they produce. Mines and quarries are common examples of such assets. The term is also used for describing such assets which get exhausted with the lapse of time, *e.g.*, copyrights, patents, trademark, etc.

2. **Liabilities** The term 'Liabilities' is used to denote amounts which a business owes and has to return or account for. They are present obligations whose amounts can be ascertained with substantial accuracy. They can be divided into two categories:

(*i*) *Current liabilities* The term 'Current Liabilities' is used to denote liabilities which will be due within a short time (usually one year or

1&2 The Institute of Chartered Accountants of India (ICAI), 'Guidance Note on Terms used in Financial Statements, 1983'. Most of the terms in this unit have been defined as per the above guidelines.

NOTES

less) and that are to be paid out of current assets or by creation of other current liabilities. Creditors for goods, bills payable, outstanding expenses are some of the examples of current liabilities.

(*ii*) *Fixed liabilities* Liabilities that will not be due for a comparatively long time (usually more than one year) are termed as 'Fixed Liabilities' or 'Long-term Liabilities'. These liabilities would continue to be treated as Fixed Liabilities if they are renewed rather than paid at maturity.

3. **Capital** The term 'Capital' is used to denote the owners' equity in the business. It is a residual claim against the assets of the business after the total liabilities are deducted. Owners' Equity, Proprietorship and Net-Worth are some of the other terms which are also used to denote Capital.

Capital may be classified into the following categories:

(*i*) *Fixed Capital* It is the capital invested in or represented by Fixed Assets.

(*ii*) *Circulating Capital* It is the capital in the form of Current or Floating Assets.

(*iii*) *Working Capital* It is the excess of Current Assets over Current Liabilities.

4. **Contingent Asset** An asset, the existence, ownership value of which may be known or determined only on the occurrence or non-occurrence of one more future uncertain events. It usually arises from unexpected events that give rise to possibility of inflow of economic benefits to the business enterprise. For example, a claim that the firm is pursuing the outcome of which is uncertain, is a contingent asset.

A contingent asset is not recognised in the books of an enterprise. It also does not require any disclosure in the financial statements. Such an asset is assessed continuously and when it becomes virtually certain that it will result in inflow to economic benefits to the enterprise, the asset and the related income may be recognised in the financial statements of the firm in which such change occurs.

5. **Contingent Liability** It 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. It is a possible obligation which may or may not arise depending upon the situation.

Following are the examples of contingent liabilities:

1. A claim against the enterprise not acknowledged as debt.
2. Uncalled liability on shares partly paid.
3. Arrears of fixed cumulative dividends.
4. Estimated amount of contracts remaining to be executed on capital account and not provided for.

An enterprise should not recognise a contingent liability. However, it may be disclosed as a note to the financial statements. Such liabilities are assessed on a continuing basis to determine whether an outflow of economic resources has become probable, if so to the extent of the probable amount, the liability will have to be recognised in the books and a provision will have to be created.

6. **Provision** An amount written off or retained by way of providing for depreciation or diminution in value of assets or for providing any known liability, the amount of which cannot determined with substantial accuracy. Examples of a provision are provision for bad and doubtful debts, a provision for discount on debtors, etc.

Difference between a Contingent Liability, a Provision and a Liability

This can be understood with the following example:

A lawsuit has been filed against a firm claiming damages of ₹1,00,000. The firm feels that the case against the firm may or may not be dismissed by the court. Such a liability is a contingent liability and may be disclosed by way of a note to the financial statements. However, if the firm feels that it may be required to pay the damages of around ₹20,000 in the suit in all probabilities, the provision to the extent of ₹20,000 for the lawsuit will be created. Finally if the court fixes the damages payable of ₹25,000 against the firms, a liability of ₹25,000 will be recognised in the books of the firm.

7. **Transaction and Event** Every economic activity is performed through transactions and events. A transaction may be a business, performance of an act or an agreement. While an event is the happening, consequence or result of a transaction.

8. **Revenue** The term 'Revenue' means income of a recurring nature from any source. The source may be sale of goods, performance of services for a customer or a client, the rental of a property, the lending of money and any other business or professional activity carried on for the purpose of earning income.

9. **Expenditure** The term includes incurring a liability disbursement of cases or transfer of property for the purpose of obtaining assets goods or services. It may be of three types:

(*i*) *Capital expenditure* An expenditure incurred for obtaining a long-term advantage for the business.

(*ii*) *Revenue expenditure* An expenditure where benefits expire within a year or which has been incurred merely to maintain the business or keep the assets in good working condition.

(*iii*) *Deferred expenditure* An expenditure or liability for which payment has been made or incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period or periods. This is also referred to as deferred revenue expenditure.

NOTES

10. **Expense** The term 'Expense' denotes the cost of services and things used for generating revenue.

An 'Expense' is to be distinguished from a Loss. An Expense is supposed to bring some benefit to the firm, whereas a Loss brings no benefit to the firm, *e.g.*, loss by theft, loss by fire, etc.

10A. **Expired Cost** That portion of an expenditure from which no further benefit is expected. Also termed as expense.

11. **Goods** The term 'Goods' means the property in which the business deals. In other words, 'Goods' are properties for resale. For example, if a furniture dealer purchases furniture for sale, the furniture so purchased will come within the definition of the term 'Goods'. However, if the furniture has been purchased by a furniture dealer for using it in his business, such furniture will come within the definition of the term 'Fixed Assets'.

12. **Debtor** The person who owes money to the business is called a 'Debtor'.

13. **Creditor** A person who has a claim for money against the business is termed as 'Creditor'.

14. **Bill of Exchange** It is a document in writing directing a certain person to pay a certain sum of money to the order of a certain person or to the bearer of the instrument. For example, if *A*, a creditor by a document in writing asks his debtor *B* to pay a sum of ₹10,000 (owed by *B* on account of purchase of certain goods) after 3 months, such a document is termed as 'Bill of Exchange'.

The document will be termed as 'Bill Receivable' for *A* (*i.e.*, the person entitled to get the payment) and a 'Bill Payable' for *B* (*i.e.*, the person who is liable to pay the money under the document).

15. **Accounts Receivable** The term includes both Debtors and Bills Receivable

16. **Accounts Payable** The term included both Creditors and Bills Payable.

17. **Discount** An allowance or a deduction allowed from an amount due is termed as 'Discount'. It may be of three types:

(*i*) *Trade discount* A deduction allowed to the buyers from the gross or catalogue price is termed as 'Trade Discount'.

(*ii*) *Quantity discount* A deduction allowed to the buyers from the gross catalogue price on making bulk purchases is termed as 'Quantity Discount'.

(*iii*) *Cash discount* A discount allowed to a debtor on prompt payment of cash is termed as 'Cash Discount'.

Trade or quantity discount is not taken into account evolute recording accounting transactions. The transactions are recorded at 'net' while cash discount is recorded in the books of account.

18. **Commission** Commission may be termed as remuneration payable to an employee for his services to the firm or to the agent for purchasing or selling goods, collection of debtors on behalf of the firm, etc. The commission is computed as a percentage of the amount involved. The commission earned is considered as an income while commission allowed is considered as an expense for the business.

Following are examples of persons to whom commission may be allowed:

(1) Selling or buying agents.

(2) Brokers and bankers.

(3) Property dealers for helping in renting out or purchase or sale of properties.

(4) Import-export agent in foreign trade.

19. **Merchandise Cost** It is the same as cost of goods sold. It is computed as follows:

	Opening Inventory	....
Add:	Net Purchases (*i.e.,* purchases *less* returns)	....
	Direct Expenses (*i.e.,* expenses incurred for acquiring the goods and making them fit for sale)	....
Less:	Closing Inventory	....
	Cost of goods sold	....

20. **Gross profit** It is the excess of the selling price over the cost of goods sold (without deducting any expenses incurred in selling the goods).

21. **Net profit/income** It is the profit left after deducting all business expenses from the Gross Profit made by the business.

21A. **Cash Profit** The net profit as increased by non-cash costs such as depreciation, amortisation etc. when the result of computation is negative, and termed as cash loss.

22. **Drawings** The withdrawal of goods or cash from the business by the owner for personal use is called 'Drawings'.

23. **Entry** Recording of a transaction in any book of account is called an 'Entry'.

24. **Insolvent** A person who is not in a position to pay his debts in full. It means that the liabilities of such a person are more than his assets.

25. **Solvent** A person who is in a position to pay his debts as they become due.

26. **Bad debts** The amount lost from a debtor on account of his inability to pay his debts.

27. **Net Assets** The excess of the book value of assets (other than fictitious assets) of an enterprise over its liabilities. This is also referred to as Net Worth or Shareholders' Funds.

28. **Working Capital** The funds available for day-to-day operations of an enterprise. Also represented by the excess of current assets over current liabilities including short-term loans.

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 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.

1.6 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 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.

1.7 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.

NOTES

- **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.

1.8 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.

Long Answer Questions

1. Define the term 'Assets'. Explain the different types of 'Assets' with suitable examples.
2. What do you understand by the term 'Liabilities of a business'? How they can be classified? Explain with suitable examples.
3. Explain the concepts of: Merchandise Cost, Gross Profit and Net Income.

1.9 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 2 ACCOUNTING CONCEPTS: PRINCIPLES AND CONVENTIONS

NOTES

Structure

2.0 Introduction
2.1 Objectives
2.2 Meaning and Types of Accounting Concepts
2.3 Accounting Convention and Its Types
2.4 Accounting Principles
2.5 Accounting Standards
2.5.1 International Accounting Standards Committee and IAS/IFRS
2.6 Answers to Check Your Progress Questions
2.7 Summary
2.8 Key Words
2.9 Self Assessment Questions and Exercises
2.10 Further Readings

2.0 INTRODUCTION

It has already been stated in Unit 1 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

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:

[1]. also termed as 'Accounting Standards'.
[2]. also termed as 'Accounting Postulates'.

NOTES

(*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

Accounting Conventions

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

2.1 OBJECTIVES

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

- Explain the meaning and types of accounting concepts
- Discuss the accounting convention and its types
- Examine the accounting principles
- Identify the accounting standards

2.2 MEANING AND TYPES OF ACCOUNTING CONCEPTS

Let's 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.

NOTES

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.

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:

$$\text{Capital (Equities)} = \text{Cash (Assets)}$$
$$10{,}000 = 10{,}000$$

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:

$$\text{Equities} = \text{Assets}$$

or $$\text{Liabilities} + \text{Capital} = \text{Assets}$$

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:

$$\text{Equities} = \text{Assets}$$

$$\text{Capital ₹10,000} = \text{Cash ₹5,000} + \text{Furniture ₹5,000}$$

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

$$\text{Equities} = \text{Assets}$$

$$\text{Capital ₹10,000} + \text{Bank Loan ₹30,000} = \text{Cash ₹35,000} + \text{Furniture ₹5,000}$$

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.

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

NOTES

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.

2.3 ACCOUNTING CONVENTION AND ITS TYPES

In this section, we will discuss the accounting conventions.

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 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

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

NOTES

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

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

2.4 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). 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

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

NOTES

(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*.

2.5 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,

NOTES

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.

2.5.1 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.

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.

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

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.

NOTES

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.

NOTES

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.

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

NOTES

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

NOTES

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

3. What is GAAP?
4. State the objective of IFRS.
5. Which International Accounting Standard deals with employee benefits?

2.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. 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.
2. 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.

3. GAAP or Generally Accepted Accounting Principles are a set of conventions, rules and procedures that constitute accepted accounting principles at any given time.
4. The basic objective of IFRSs is to make international comparison of financial statements of business enterprises as easy as possible.
5. The International Accounting Standard 19 or IAS 19 deals with employee benefits.

NOTES

2.7 SUMMARY

- 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 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.

NOTES

- 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.

2.8 KEY WORDS

- **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.

2.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Define the term Convention of Conservations.
2. Define the term Convention of Materiality.
3. Define the term Convention of Disclosure.

Long Answer Questions

NOTES

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.
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

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 RECORDING OF TRANSACTIONS

NOTES

Structure

3.0 Introduction
3.1 Objectives
3.2 Meaning of Assets, Liabilities and Equity, and Modern Approach to Classify Accounts
3.2.1 Classification of Accounts under Modern Approach Method
3.3 Journal
3.3.1 Rules of Debit and Credit
3.3.2 Compound Journal Entry
3.3.3 Opening Entry
3.4 Answers to Check Your Progress Questions
3.5 Summary
3.6 Key Words
3.7 Self Assessment Questions and Exercises
3.8 Further Readings

3.0 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.

3.1 OBJECTIVES

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

- Discuss the classification of accounts under Modern Approach Method
- Describe the meaning and rules of journal

- Explain the different types of accounts in journal
- Recall the concepts of compounding and opening journal entries

3.2 MEANING OF ASSETS, LIABILITIES AND EQUITY, AND MODERN APPROACH TO CLASSIFY ACCOUNTS

The meaning of assets and liabilities has already been discussed under Accounting Terminologies in Unit 1. The meaning of equity is also stated while describing the concept of Accounting Equation in the same unit. You have also learned in Unit 1 how financial transactions affect an accounting equation. In this section, you will learn about the modern approach to classification of accounts.

3.2.1 Classification of Accounts under Modern Approach Method

According to modern approach, the accounts are classified as asset accounts, liability accounts, capital or owner's equity accounts, withdrawal accounts, revenue/income accounts and expense accounts.

- **Asset accounts:** Assets are things or items of value owned by a business and are usually divided into tangible or intangible. Tangible assets are physical items such as building, machinery, inventories, receivables, cash, prepaid expenses and advance payments to other parties. Intangible assets normally include non-physical items and rights. Examples of intangible assets include goodwill, trademarks, copyrights, patent rights and brand recognition etc.

  A separate account for each tangible and intangible asset is maintained by the business to record any increase or decrease in that account.
- **Liability accounts:** Liabilities are obligations or debts payable to outsiders or creditors. The title of a liability account usually ends with the word "payable". Examples include accounts payable, bills payable, wages payable, interest payable, rent payable and loan payable etc. Besides these, any revenue received in advance is also a liability of the business and is known as unearned revenue. For example, a marketing firm may receive marketing fee from its client for the forthcoming quarter in advance. Such unearned revenue would be recorded as a liability as long as the related marketing services against it are not provided to the client who has made the advance payment.
- **Capital or owner's equity accounts:** Capital is the owner's claim against the assets of the business and is equal to total assets less all liabilities to external parties. The balance in capital account increases with the introduction of new capital and profits earned by the business and decreases as a result of withdrawals and losses sustained by the business.

NOTES

In sole proprietorship, a single capital account titled as owner's capital account or simply capital account is used. In partnership or firm, each partner has a separate capital account like John's capital account, Peter's capital account etc. In corporate form of business there are many owners known as stockholders or shareholders and the title capital stock account is used to record any change in the capital.

- **Withdrawal accounts:** Withdrawals are cash or assets taken by a business owner for his personal use. In sole proprietorship and partnership, an account titled as drawings account is used to account for all withdrawals. In corporate form of business withdrawals are more systematic and usually termed as distributions to stockholders. The account used for recording such distributions is known as dividend account.
- **Revenue or income accounts:** Revenue is the inflow of cash as a result of primary activities such as provision of services or sale of goods. The term income usually refers to the net profit of the business derived by deducting all expenses from revenue generated during a particular period of time. However, in accounting and finance, the term is also used to denote all inflows of cash resulted by those activities that are not primary revenue generating activities of the business. For example, a merchandising company may have some investment in an oil company. Any dividend received from oil company would be termed as dividend income rather than dividend revenue. Other examples of income include interest income, rent income and commission income etc. The businesses usually maintain separate accounts for revenues and all incomes earned by them.
- **Expense accounts:** Any resource expended or service consumed to generate revenue is known as expense. Examples of expenses include salaries expense, rent expense, wages expense, supplies expense, electricity expense, telephone expense, depreciation expense and miscellaneous expense.

3.3 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.

3.3.1 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.

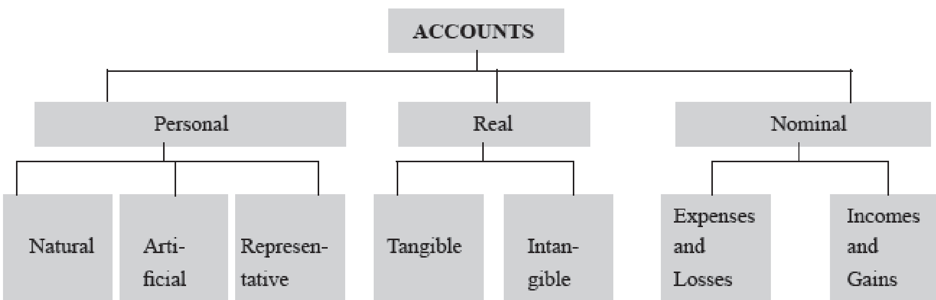
On this basis, it becomes necessary for the business to keep an account of:

(*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:



NOTES

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.

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 3.1. 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:

NOTES

	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
(*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 3.2. 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 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,

NOTES

purchase and return of goods. Hence, Goods Accounts can be classified into the following categories:

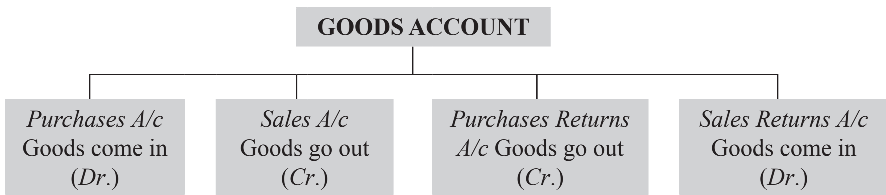
(*i*) *Purchases Account* The account is meant for recording all purchases of goods. Goods "come in" on purchasing of goods and, therefore, the Purchases Account is debited on purchase of goods.

(*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.

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



3.3.2 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 3.3. 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.

NOTES

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
	(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)				

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.

NOTES

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.

3.3.3 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 3.4. 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

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

NOTES

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 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.

NOTES

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	
		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	

Sl. No.	Date	Particulars		L.F.	Debit ₹	Credit ₹
		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

NOTES

Check Your Progress

1. How is income defined in accounting and finance?
2. How are withdrawal accounts used in sole proprietorship, partnership, and corporate firms?
3. What are the categories of personal accounts?
4. State the rule for recording transactions in the nominal accounts.
5. What comes under the opening entry?

3.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The term income usually refers to the net profit of the business derived by deducting all expenses from revenue generated during a particular period of time. However, in accounting and finance, the term is also used to denote all inflows of cash resulted by those activities that are not primary revenue generating activities of the business.
2. In sole proprietorship and partnership, an account titled as drawings account is used to account for all withdrawals. In corporate form of business withdrawals are more systematic and usually termed as distributions to stockholders. The account used for recording such distributions is known as dividend account.

NOTES

3. The categories of personal accounts are: natural personal accounts, artificial personal accounts and representative personal accounts.
4. The rule for recording transactions in the nominal accounts is: Debit all the expenses and credit all gains and incomes.
5. The opening entry comprises of an entry in which 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.

3.5 SUMMARY

- The accounting cycle involves the following stages: recording of transactions, classifying the transactions, summarising the transactions and interpreting the results.
- According to modern approach, the accounts are classified as asset accounts, liability accounts, capital or owner's equity accounts, withdrawal accounts, revenue/income accounts and expense accounts.
- The Journal records all daily transactions of a business into the order in which they occur. It is a book containing a chronological record of transactions.
- 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: transactions relating to persons, relating to properties and assets and relating to incomes and expenses. Thus three types of accounts which are prepared are personal, real and nominal accounts.
- The term goods include articles purchased by the business for resale. 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: purchases account, sales account, purchases returns account and sales returns account.
- 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".

3.6 KEY WORDS

NOTES

- **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.
- **Personal Accounts:** These are the accounts of persons with whom the business deals.
- **Real Accounts**: These are the accounts of tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

3.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the meaning of the term "Journal" and state its significance.
2. What is the meaning of the term "Real Accounts"?
3. What do you understand by the term Accounting Cycle.
4. What is an opening entry?

Long Answer Questions

1. Explain the different categories in which the accounting transactions can be classified. Also state the rule of 'debit and credit' in this connection.
2. Explain the different rules for journalising the transaction with appropriate illustrations.
3. Briefly explain the difference between:
   (i) Personal and Impersonal Accounts.
   (ii) Real Accounts and Nominal Accounts.

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.

UNIT 4 SECONDARY BOOKS (SUBSIDIARY BOOKS)

NOTES

Structure

4.0 Introduction
4.1 Objectives
4.2 Different Types of Journals
  4.2.1 Cash Journal or Book
  4.2.2 Petty Cash Book
  4.2.3 Purchases Journal
  4.2.4 Sales Returns Journal
  4.2.5 Purchases Returns Journal
4.3 Ledger
  4.3.1 Posting
4.4 Answers to Check Your Progress Questions
4.5 Summary
4.6 Key Words
4.7 Self Assessment Questions and Exercises
4.8 Further Readings

4.0 INTRODUCTION

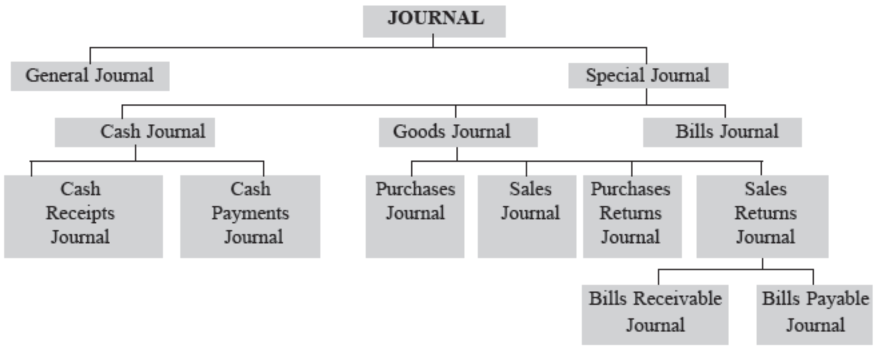
It has already been explained in Unit 3 that Journal is the book of prime entry. It means all business transactions are to be first recorded in the Journal. However, in a big business recording of all transactions in one Journal will not only be inconvenient but also cause delay in collecting information required. The Journal is, therefore, sub-divided into many **subsidiary books**. This sub-division results in the following advantages:

(*i*) **Convenience** As stated above maintenance of one Journal only will make it quite bulky or difficult to handle. Sub-division of Journal only will result in reducing the size of Journal and making it convenient to handle.

(*ii*) **Division of labour** Sub-division of Journal helps in division of labour since different persons can write different Journals.

(*iii*) **Classified information** Each Journal provides information relating to a particular aspect of the business. For example, a Purchases Journal gives information about the total credit purchases made by the business. Similarly, a Sales Journal gives information about the total credit sales made by the business. Thus, the businessman gets the information relating to different aspects of the business in a classified form in the shortest possible time.

NOTES



Each of the above types of Journals have been explained in this unit.

4.1 OBJECTIVES

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

- Identify the different types of journals
- Describe the concept of cash book and petty cash book
- Discuss the concept of Ledger and posting
- Examine the relationship between journal and ledger

4.2 DIFFERENT TYPES OF JOURNALS

Let's 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.

NOTES

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.

NOTES

(*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.

4.2.1 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 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:

NOTES

Illustration 4.1. 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.

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

NOTES

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:

(*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 4.2. 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.

NOTES

Solution:

Dr. CASH BOOK *Cr.*

Date	*Particulars*	*L.F.*	*Dis-count (₹)*	*Cash ₹*	*Date*	*Particulars*	*L.F.*	*Dis-count (₹)*	*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

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.

NOTES

(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.

Illustration 4.3.

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						

NOTES

Ledger

Dr. SALES ACCOUNT Cr.

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

SURESH

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

RENT ACCOUNT

Jan. 4	To Bank A/c		2,000		

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

NOTES

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

NOTES

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 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:

NOTES

(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

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 4.4. 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.

Solution:

NOTES

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

NOTES

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.

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.

4.2.2 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

NOTES

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 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 4.5. 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

NOTES

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.

NOTES

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			

NOTES

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			

4.2.3 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 4.6. 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

NOTES

Jan. 24 Purchased from K.C. & Co. on credit:

30 Electric Plugs @ ₹20

40 Table Fans @ ₹200

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*)

			Jan. 4	By Purchases	700

BAJAJ & CO. (*Folio 12*)

			Jan. 8	By Purchases	1,100

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

			Jan. 24	By Purchases	8,600

PURCHASES ACCOUNT (*Folio 14*)

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.

NOTES

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 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 4.7. 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

NOTES

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.

4.2.4 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.

NOTES

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

4.2.5 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:

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

NOTES

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.

Check Your Progress

1. List the types of special journal.
2. Define trade discount.
3. Give some examples of petty cash expenses.

4.3 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.

NOTES

4.3.1 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.

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.

NOTES

(*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.

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

NOTES

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 4.8. 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:

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

NOTES

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 4.9. 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:

NOTES

JOURNAL

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

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			

NOTES

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.

Check Your Progress

4. What is the order of books in which the transactions are recorded in double-entry system?
5. Define the accounting term 'Balancing the Account'.

4.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. The types of special journal are cash journal, goods journal, bills journal, and bills payable journal.
2. 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.
3. Some examples of petty cash expenses are: postage, cartage, stationary, cleaning charges, etc.
4. In the double entry system, 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.
5. The 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'.

4.5 SUMMARY

- Journal is the book of prime entry. It means all business transactions are to be first recorded in the Journal. However, in a big business recording of all transactions in one Journal will not only be inconvenient but also cause delay in collecting information required. The Journal is, therefore, sub-divided into many subsidiary books.
- The general journal is meant for recording all such transactions for which no special journal has been kept by the business.
- The term 'Special Journal' means a journal which is meant for a special purpose. It has subtypes including a cash journal, goods journal and a bills journal.
- The Cash journal is meant for recording all cash transactions. It has various types including a simple cash book, two-columnar cash book, three-columnar cash book, multi-columnar cash book, cash receipts books and cash payments books.
- Petty Cash Book is maintained by the business to record petty cash expenses of the business, such as postage, cartage, stationery, cleaning charges, etc. The Petty Cash Book is usually maintained on the basis of Imprest system.
- The Purchases Journal is meant for recording credit purchases of goods. It is also known as the Purchases or Bought Day Book. The Sales journal is meant for recording all sales of goods on credit. This book is also known as Sales or Sold Day Book.

- The Classifying of the recorded transactions is done in the Ledger. It may be kept in any of the two forms: bound ledger and loose-leaf ledger.
- The term posting means transferring the debit and credit items of the Journal to their respective accounts in the Ledger.
- The 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.'

4.6 KEY WORDS

- **Bills Journal:** A journal meant for recording all transactions relating to Bills of Exchange or Promissory Notes received or issued by the business.
- **Cash Journal:** A journal meant for recording all cash transactions.
- **Contra Entry:** An accounting entry which is recorded on both the debit and credit sides of the Cash Book.
- **General Journal:** A journal meant for recording all such transactions for which no special journal has been kept by the business.
- **Goods Journal**: A journal meant for recording all credit transactions relating to goods.
- **Imprest:** The amount advanced to the petty cashier in the beginning of a period. It is also termed as float.
- **Petty Cash Book:** A book meant for recording all petty cash expenses of the business.
- **Special Journal:** A journal meant for recording transactions of a specific type.
- **Ledger:** A book containing different accounts of an entity.
- **Posting:** Transferring the debit and credit items from the Journal to the respective accounts in the Ledger.
- **Trial Balance:** A statement containing the various ledger balances on a particular date.
- **Voucher System:** A plan and method of procedure for the verifications, recording and payment of all items (other than items to be paid from petty cash) which require disbursement of cash.

4.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. Explain briefly the Imprest System of Petty Cash Book.
2. What do you understand by subsidiary books? Describe the objectives of preparing them.
3. What do you mean by sub-division of Journal?

Long Answer Questions

1. What is a special purpose subsidiary book? Give a specimen of such a book showing at least five entries.
2. Explain the different types of Goods Journals with suitable examples.

4.8 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.

BLOCK - II

FINAL ACCOUNTS AND ADJUSTMENTS

UNIT 5 TRIAL BALANCE AND RECTIFICATION OF ERRORS

Structure

5.0 Introduction
5.1 Objectives
5.2 Trial Balance
5.3 Errors in Accounting and Its Rectification
    5.3.1 Location of Errors
    5.3.2 Rectifying Accounting Entries
5.4 Answers to Check Your Progress Questions
5.5 Summary
5.6 Key words
5.7 Self Assessment Questions and Exercises
5.8 Further Readings

5.0 INTRODUCTION

The basic information for preparing final accounts (discussed in Units 6 and 7) is supplied by the Trial Balance. Thus, the accuracy of the Trial Balance determines to a great extent the accuracy or otherwise of the information provided by Final Accounts. However, the Trial Balance provides only proof of the arithmetical accuracy of the books of accounts. It simply assures that for every debit there is an equivalent credit entry. It means that in spite of an agreed Trial Balance, it is not necessary that there are not errors in the books of accounts. For example, if a transaction is not at all recorded in the books of accounts, the Trial Balance will tally, but the books of accounts cannot be termed as accurate. In any case, if the two sides of the Trial Balance do not tally, it is a definite proof of this fact that there are certain errors in the books of accounts. Thus, errors may be there in recording, classifying and summarising the financial transactions whether the Trial Balance tallies or whether it does not tally.

NOTES

5.1 OBJECTIVES

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

- Describe the trial balance
- Explain the preparation of a trial balance
- Discuss the procedure for rectification of error in accounting
- Identifying the rectifying accounting entries

5.2 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. For example, with the balances of the ledger accounts prepared in Illustration 4.9 (of the previous unit), the Trial Balance can be prepared as follows:

TRIAL BALANCE
as on 31st January

Particulars	Debit (₹)	Credit (₹)
Cash Account	12,000	
Capital Account		10,000
Purchases Account	4,000	
Mohan		2,000
Sales Account		4,000
	16,000	16,000

Thus, the two sides of the Trial Balance tally. It means the books of accounts are arithmetically accurate.

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 5.1. 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
Bharat		5,000
Plant Account	5,300	

NOTES

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

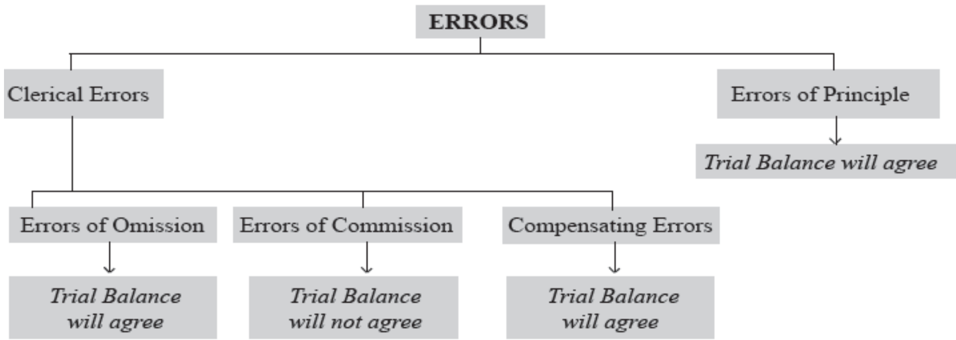
Check Your Progress

1. Which accounting tool helps in finding out if the books of accounts are arithmetically accurate?
2. Why is the total method of preparation of a Trial Balance not generally followed?

5.3 ERRORS IN ACCOUNTING AND ITS RECTIFICATION

NOTES

Errors in accounting can broadly be classified as shown in the following chart:



Each of the above types of errors has been explained on the next page:

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 might 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. **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

NOTES

₹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.

II. Errors of Principle

Errors of principle are committed in those cases where a proper distinction between revenue and capital items is not made, *i.e.*, a capital expenditure is taken as a revenue expenditure or *vice versa.* Similarly, a capital receipt may have been taken as a revenue receipt or *vice versa*. 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 also are difficult to be located.

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.

5.3.1 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.

NOTES

5.3.2 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.

Overcosting 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 (Being excess credit to sales account, now rectified)	Dr.	50	

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

NOTES

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 (incl. 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.

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.* ₹
Suresh	Dr.	45	
To Suspense Account			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.

NOTES

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	
	Suresh	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.

Illustration 5.2. The Trial Balance of Arun on 31st December, 2017, showed a difference of ₹580 (excess debit). It was put to a Suspense Account and the books were closed. On going through the books in January, 2018, the following errors were discovered. You are required to pass suitable rectifying journal entries and prepare the Suspense Account.

1. ₹540 received from M. Mehta was posted to the debit of his account.
2. ₹100 being Purchases Returns was posted to the debit of Purchases Account.

NOTES

3. Discount ₹200 received, entered in the cash book was not posted to the Ledger.
4. ₹574 paid for repairs to motor-car was debited to the motor-car account as ₹174.
5. A sale of ₹350 to Sethi was entered in the Sales Book as of ₹530.
6. While carrying forward total of one page in Kalra's Account, the amount of ₹250 was written on the credit side instead of debit side.
7. The purchase of machinery on 1st January, 2017 for ₹6,000 was entered in the Purchases Account.

Solution:

JOURNAL PROPER

Sl. No.	*Particulars*		*L.F.*	*Dr.* ₹	*Cr.* ₹
1.	Suspense A/c	Dr.		1,080	
	To M. Mehta				1,080
	(Being ₹540 received from M. Mehta debited to his account, the error now rectified)				
2.	Suspense A/c	Dr.		200	
	To Purchases A/c				100
	To Purchases Returns A/c				100
	(Being purchases returns of ₹100 posted to the debit of Purchases A/c, the error now rectified)				
3.	Suspense A/c	Dr.		200	
	To Discount A/c				200
	(Being discount received not posted to Discount A/c, the error now rectified)				
4.	Repairs A/c	Dr.		574	
	To Motor Car A/c				174
	To Suspense A/c				400
	(Being repairs to motor car, ₹574, debited to Motor Car A/c as ₹174 wrongly, the error now rectified)				
5.	Sales A/c	Dr.		180	
	To Sethi				180
	(Being sales of ₹350 to Sethi entered in the Sales Book as of ₹530, the error now rectified)				
6.	Kalra	Dr.		500	
	To Suspense A/c				500
	(Being Kalra's A/c credited by ₹250 instead of being debited by ₹250, the error now rectified)				
7.	Machinery A/c	Dr.		6,000	
	To Purchases A/c				6,000
	(Being purchases of machinery debited to Purchases A/c instead of Machinery A/c, the error now rectified)				

Notes:

1. The account of M. Mehta should have been credited by ₹540. It has been debited. In order to set the matters right, it is necessary to credit his account by ₹1,080 (*i.e.*, to cancel unnecessary debit of ₹540 and to give him credit of ₹540).
2. The Purchases Returns Account should have been credited by a sum of ₹100 on account of return of the goods. It has not been at all credited. It has, therefore, been credited by ₹100.

NOTES

The Purchases Account should not have been at all debited. It has, therefore, been credited by ₹100. Suspense Account has been debited by ₹200, since no other account is available and it must have been credited earlier on account of these errors.

3. The amount of discount received is credited to the Discount Account. It has not been done. Discount Account, has therefore, been credited now. Suspense Account has been debited because it must have been credited earlier on account of this error.
4. Repairs to motor-car is a revenue expenditure. It should have been debited to the Repairs Account. It has not been done. The Repairs Account has, therefore, been debited by ₹574. Motor Car Account has been unnecessarily debited by ₹174. It should, therefore, be credited by this amount. The difference has been put to the Suspense Account.
5. The sale to Sethi was only of ₹350, but it has been recorded as a sale of ₹530. It means the account of Sethi has been unnecessarily debited by ₹180. It has, therefore, been credited by this amount. Sales Account has been credited by ₹530, instead of ₹350. It has, therefore, been debited by ₹180, the excess credit.
6. The account of Kalra should have been debited by ₹250. It has been credited by ₹250. His account should, therefore, be debited by ₹500 to cancel unnecessary credit of ₹250 and to keep his account debited by ₹250. Suspense Account has been credited by ₹500 since no other account is involved.
7. Purchase of Machinery of ₹6,000 should have been debited to the Machinery Account. It was not done. The Machinery Account has, therefore, been debited by ₹6,000. Purchases Account was unnecessarily debited by ₹6,000. It has, therefore, been credited by the above amount.

Tutorial Note. While passing the rectifying journal entries, the students should put the difference to the Suspense Account, in case it has been opened and no other account is available.

Dr. SUSPENSE ACCOUNT *Cr.*

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
To M. Mehta	1,080	By Balance b/d	580
To Purchases	100	By Repairs Account	400
To Purchases Returns A/c	100	By Kalra	500
To Discount A/c	200		
	1,480		1,480

Illustration 5.3. In taking out a Trial Balance, a Book-keeper finds that debit total exceeds the credit total by ₹352. The amount is placed to the credit of a newly opened Suspense Account. Subsequently, the following mistakes were discovered. You are required to pass the necessary entries for rectifying the mistakes, and show the Suspense Account:

(*a*) Sales Day Book was overcast by ₹100.
(*b*) A sale of ₹50 to Shri Ram was wrongly debited to Shri Krishna.
(*c*) General Expenses ₹18 were posted as ₹80.
(*d*) Cash received from Shri Govind was debited to his account ₹150.
(*e*) While carrying forward the total of one page of the Purchases Book to the next, the amount of ₹1,235 was entered as ₹1,325.

NOTES

Solution:

Sl. No.	*Particulars*	*Dr.* ₹	*Cr.* ₹
(*a*)	Sales A/c Dr. To Suspense A/c (Being overcosting of Sales Day book rectified)	100	100
(*b*)	Shri Ram Dr. To Shri Krishna (Being the wrong debit given to Shri Krishna rectified)	50	50
(*c*)	Suspense A/c Dr. To General Expenses A/c (Being rectification of the wrong posting made in General Expenses Account)	62	62
(*d*)	Suspense A/c Dr. To Shri Govind (Being rectification of the wrong debit given to Shri Govind)	300	300
(*e*)	Suspense A/c Dr. To Purchases A/c (Being rectification of the wrong carry forward in the Purchases Book)	90	90

SUSPENSE ACCOUNT

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
To General Expenses	62	By Balance b/d	352
To Govind	300	By Sales	100
To Purchases	90		
	452		452

Illustration 5.4. A trader has tallied the Trial Balance by putting the difference of ₹310 to the debit of Suspense Account and has prepared a Trading and Profit & Loss Account and the Balance Sheet. On subsequent scrutiny the books disclosed several errors as detailed below. Rectify these errors and prepare Suspense Account:

(*i*) A sale of goods to *X* for ₹350 has been credited to his account.

(*ii*) Goods purchased from *Y* amounting to ₹750 were entered in the Purchases Day Book but were omitted from *Y*'s Account in the Creditors' Ledger.

(*iii*) An Office Typewriter purchased for ₹500 has been passed through the Purchases Account.

(*iv*) Goods returned to S. Sen. valued ₹75 were debited to P. Sen's Account.

(*v*) Repairs to Office Car valued ₹750 were debited to the Office Car Account.

(*vi*) Goods sold to R. Banerjee valued ₹730 have been posted in his account as ₹370.

NOTES

Solution:

Sl. No.	*Particulars*		*Dr. ₹*	*Cr. ₹*
(*i*)	*X*	Dr.	700	
	To Suspense A/c			700
	(Being amount of sale of ₹350 wrongly credited to Mr. *X* error now rectified)			
(*ii*)	Suspense A/c	Dr.	750	
	To *Y*			750
	(Being amount of goods purchased from Mr. *Y* not credited to his account now recorded)			
(*iii*)	Office Equipment A/c	Dr.	500	
	To Profit & Loss Adjustment A/c			500
	(Being cost of typewriter purchased wrongly debited to purchases account, error now rectified)			
(*iv*)	S. Sen	Dr.	75	
	To P. Sen			75
	(Being amount of goods returned to S. Sen wrongly debited to P. Sen, now rectified)			
(*v*)	Profit & Loss Adjustment Account	Dr.	750	
	To Office Car A/c			750
	(Being amount of repairs of office car wrongly capitalised, now rectified)			
	R. Banerjee	Dr.	360	
	To Suspense A/c			360
	(Being goods sold to R. Banerjee for ₹730 debited to him as ₹370, now rectified)			
	Capital A/c	Dr.	250	
	To Profit & Loss Adjustment A/c			250
	(Being balance of Profit & Loss Adjustment Account transferred)			

SUSPENSE ACCOUNT

Particulars	*Amount ₹*	*Particulars*	*Amount ₹*
To Balance b/d	310	By *X*	700
To *Y*	750	By R. Banerjee	360
	1,060		1,060

Check Your Progress

3. Which category of errors comprises of the compensating errors?
4. Define Suspense Account.

5.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The Trial Balance is the accounting tool which helps in finding out if the books of accounts are arithmetically accurate in the condition that the two sides of the Trial Balance tally.

2. The total method of the preparation of a Trial Balance is not generally followed since it does not help in the preparation of the financial statements.
3. The clerical errors is the category of errors which comprises of the compensating errors.
4. The Suspense Account is an account to which the difference in the Trial Balance is put temporarily until the errors are locating and the suitable accounting entries passed.

5.5 SUMMARY

- 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: Checking of the arithmetical accuracy of the accounting entries, basis for financial statements and summarised ledger.
- A Trial Balance may be prepared according to any of the two methods: Total Method, Balance Method and Total and Balance Method.
- The accuracy of the Trial Balance determines to a great extent the accuracy or otherwise of the information provided by Final Accounts. However, the Trial Balance provides only proof of the arithmetical accuracy of the books of accounts. It simply assures that for every debit there is an equivalent credit entry. It means that in spite of an agreed Trial Balance, it is not necessary that there are not errors in the books of accounts.
- Errors can broadly be classified as: Clerical Errors and Errors of Principle. Clerical Errors include the following errors: Errors of omission, Errors of commission, and Compensating errors. Errors of principle are committed in those cases where a proper distinction between revenue and capital items is not made, i.e., a capital expenditure is taken as a revenue expenditure or vice versa. Similarly, a capital receipt may have been taken as a revenue receipt or vice versa.
- 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.

- 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.
- 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".
- 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 and the Suspense Account is closed.
- 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.
- 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.

5.6 KEY WORDS

- **Trial Balance:** A statement containing the various ledger balances on a particular date.
- **Compensating Errors:** Errors which compensate each other.
- **Errors of Commission:** Errors on account of wrong balancing of an account, wrong posting, wrong carry forward, wrong totalling, etc.
- **Errors of Omission:** Errors committed because of complete omission of a transaction from the books of accounts.
- **Errors of Principle:** Errors committed because of failure to make a proper distinction between revenue and capital items.
- **Suspense Account:** An account to which the difference in the trial balance has been put temporarily.

5.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. What is a trial balance? Explain its objectives.
2. Explain the term ‘‘Compensating Errors’’.
3. Explain the term ‘‘Suspense Account’’.

Long Answer Questions

1. Explain the different types of errors with suitable example and state how they affect the Trial Balance.
2. ‘‘A Trial Balance is only a prima facie evidence of the accuracy of the books of accounts”. Comment.
3. In case of disagreement of the Trial Balance what steps would you take to locate the errors?

5.8 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 6 FINAL ACCOUNTS- I

NOTES

Structure

6.0 Introduction
6.1 Objectives
6.2 Meaning, Objectives and Characteristics of Final Accounts
6.2.1 Characteristics of Final Accounts
6.2.2 Objectives of Final Accounts
6.3 Adjustments Before Preparing Final Accounts
6.4 Answers to Check Your Progress Questions
6.5 Summary
6.6 Key Words
6.7 Self Assessment Questions and Exercises
6.8 Further Readings

6.0 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, which will be discussed in the next unit.

In this unit, you will also learn about various adjustments to be considered before final accounts are prepared.

6.1 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

6.2 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.

6.2.1 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.

6.2.2 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.

NOTES

6.3 ADJUSTMENTS BEFORE PREPARING FINAL ACCOUNTS

In Unit 7 of this book, we will study the important equations and entries which are required to prepare the Trading and Profit and Loss Account and the Balance Sheet. 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:

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.

NOTES

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	

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

NOTES

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 6.1. 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.

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

The items will appear in the Final Accounts as follows:

Dr. PROFIT AND LOSS ACCOUNT Cr.

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

BALANCE SHEET

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

NOTES

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

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:

NOTES

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.

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 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 6.2. 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	

NOTES

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

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

NOTES

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

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

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 6.4. 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.

NOTES

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.	300	
	To Rent received in Advance A/c			300
	(Being rent received in advance for three months)			
	Interest A/c	Dr.	500	
	To Interest received in Advance A/c			500
	(Being interest received in advance)			

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		

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

Illustration 6.5. 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 6.6. The following are the extracts from the Trial Balance of a firm.

NOTES

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.

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 6.7. 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.	2,500	
	To Mahesh		2,500
	(Being ₹2,500 became irrecoverable)		

PROFIT AND LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	*Particulars*	₹
To Bad Debts	5,000			
(as given in the				
Trial Balance)				
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

NOTES

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 6.8. 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.

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 6.9. 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.

NOTES

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

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.

NOTES

Illustration 6.10. 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	

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.	1,000	
	To Sundry Debtors A/c			1,000
	(Being discount allowed to debtors)			
	Profit & Loss A/c	Dr.	4,900	
	To Provision for Bad Debts A/c			4,900
	(Being provision for bad debts created @10% on debtors of ₹49,000)			
	Profit & Loss A/c	Dr.	2,205	
	To Provision for Discount			2,205
	(Being provision for discount created @5% on debtors of ₹44,100 (*i.e.*, ₹49,000 – ₹4,900)			

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		

NOTES

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 6.11. 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)			

NOTES

Date	Particulars		Dr. ₹	Cr. ₹
	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	3,000.00			
(as given in the Trial Balance)				
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	1,000.00			
(as given in the Trial Balance)				
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

NOTES

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 6.12. 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%.

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.	1,500	
	To Discount A/c			1,500
	(Being additional discount received from Creditors)			
	Discount A/c	Dr.	2,500	
	To Reserve for Discount on Creditors			2,500
	(Being discount received transferred to Reserve for Discount A/c)			
	Reserve for Discount A/c	Dr.	3,350	
	To Profit and Loss A/c			3,350
	(Being amount credited to Profit and Loss Account for maintaining Reserve for Discount Account @10% on creditors)			

NOTES

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

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 6.13. 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.

NOTES

(*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		

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

* 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

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.

(*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 6.14. 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	

NOTES

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

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		

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.

NOTES

6.4 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

6.5 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,

NOTES

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.

6.6 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.

6.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

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.

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.

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 FINAL ACCOUNTS- II

NOTES

Structure

7.0 Introduction
7.1 Objectives
7.2 Trading Account
7.3 Profit and Loss Account
7.4 Balance Sheet
7.4.1 Treatment of Adjustments
7.5 Practical Problems
7.6 Answers to Check Your Progress Questions
7.7 Summary
7.8 Key Words
7.9 Self Assessment Questions and Exercises
7.10 Further Readings

7.0 INTRODUCTION

In the previous unit, we have learnt about the meaning, objectives and characteristics of final accounts. We also learnt about some of the adjustment entries which need to be done in the final accounts. In this unit, we will have a look at the two most important accounting tools which need to be made to ascertain a better picture of the financial position of an enterprise. In this unit, we will learn the meaning and preparation of the Trading and 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.

7.1 OBJECTIVES

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

- 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

7.2 TRADING ACCOUNT

NOTES

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 7.1. 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 7.1, 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 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 7.2. Taking the figures given in Illustration 7.1, 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 7.3. 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

NOTES

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 7.4. Calculate the amount of the profit made by the trader with the help of data given in Illustration 7.3, 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 7.5. 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

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.

NOTES

TRADING ACCOUNT

for the period ending ...

Dr. Particulars		Amount ₹	Particulars		Cr. 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 7.6. 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

for the year ending 31-12-2017

Dr. Particulars		₹	Particulars		Cr. ₹
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.

NOTES

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 11.6 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.

NOTES

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.

NOTES

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 Ratio1 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

1. Gross Profit ÷ Sales × 100

NOTES

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.

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

1. What is the term given to profit disclosed by the Trading Account?
2. State the principle on which the valuation of closing stock is done.

7.3 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 Capital A/c*	....
To Commission	....		
To Advertisements	....		
To Bad Debts	....		
To Discount	....		
To Net Profit Transferred to Capital Account*	....		
	....		....

* Only one figure of profit or loss will appear.

NOTES

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:

$$= ₹10{,}000 \times \frac{10}{100}\ ₹1{,}000$$

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.

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 7.7. 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	By Sales	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

3. State the entry for Salaries less Tax in the Profit and Loss Account.
4. What is the difference between cash discount and trade discount on account of disclosure?

7.4 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.[2] 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. In case of Joint Stock Companies the proforma of balance sheet has been prescribed by Schedule III (Part-I) of the Companies Act, 2013.

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.

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.

NOTES

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.’’[3] 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.

(*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)

3. Paul Grady, ‘‘Inventory of Generally Accepted Accounting Principles for Business Enterprises’’, pages 234-35.

(*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)

Illustration 7.8. From the following balance extracted from the books of M/s Rajendra Kumar Gupta & Co., pass the necessary closing entries, prepare a Trading and Profit and Loss Account and a Balance Sheet.

Particulars	₹	*Particulars*	₹
Opening Stock	1,250	Plant and Machinery	6,230
Sales	11,800	Returns Outwards	1,380
Depreciation	667	Cash in hand	895
Commission (Cr.)	211	Salaries	750
Insurance	380	Debtors	1,905
Carriage Inwards	300	Discount (Dr.)	328
Furniture	670	Bills Receivable	2,730
Printing Charges	481	Wages	1,589
Carriage Outwards	200	Returns Inwards	1,659
Capital	9,228	Bank Overdraft	4,000
Creditors	1,780	Purchases	8,679
Bills Payable	541	Petty Cash in hand	47
		Bad Debts	180

The value of stock on 31st December, 2017 was ₹3,700.

NOTES

Solution:

JOURNAL

Date	Particulars		Dr. Amt ₹	Cr. Amt ₹
	Trading A/c	Dr.	13,477	
	To Opening Stock A/c			1,250
	To Purchases A/c			8,679
	To Wages A/c			1,589
	To Returns Inward A/c			1,659
	To Carriage Inward A/c			300
	(For closing all accounts to be debited to Trading A/c)			
	Sales A/c	Dr.	11,800	
	Returns Outward A/c	Dr.	1,380	
	To Trading A/c			13,180
	(For closing all accounts to be credited to the Trading A/c)			
	Trading A/c	Dr.	3,403	
	To Profit and Loss A/c			3,403
	(For transfer of Gross Profit)			
	Profit and Loss A/c	Dr.	2,986	
	To Depreciation A/c			667
	To Insurance A/c			380
	To Printing Charges A/c			481
	To Carriage Outward A/c			200
	To Salaries A/c			750
	To Discount A/c			328
	To Bad Debts A/c			180
	(For closing all indirect and selling expenses accounts)			
	Commission A/c	Dr.	211	
	To Profit and Loss A/c			211
	(For closing commission account)			
	Profit and Loss A/c	Dr.	628	
	To Capital A/c			628
	(For transferring Net Profit to Capital Account)			

TRADING AND PROFIT & LOSS ACCOUNT

for the year ending 31st December, 2017

Particulars		₹	Particulars		₹
To Opening Stock		1,250	By Sales	11,800	
To Purchases	8,679		*Less:* Returns		
Less: Returns Outward	1,380	7,299	Inwards	1,659	10,141
To Wages		1,589	Closing Stock		3,700
To Carriage Inward		300			
To Gross Profit c/d		3,403			
		13,841			13,841
To Depreciation		667	By Gross Profit b/d		3,403
To Insurance		380	By Commission		211
To Printing Charges		481			
To Carriage Outwards		200			
To Salaries		750			
To Discount		328			
To Bad Debts		180			
To Net Profit		628			
		3,614			3,614

BALANCE SHEET

as on 31st December, 2017

Liabilities		₹	*Assets*	₹
Bills Payable		541	Cash	895
Creditors		1,780	Petty Cash	47
Bank Overdraft		4,000	Bills Receivable	2,730
Capital	9,228		Debtors	1,905
Add: Net Profit	628	9,856	Closing Stock	3,700
			Plant and Machinery	6,230
			Furniture	670
		16,177		16,177

NOTES

Illustration 7.9. From the following Trial Balance prepare the Manufacturing Account, Trading and Profit and Loss Account for the year ending 31st March, 2017 and the Balance Sheet as on that date:

Particulars	*Debit* ₹	*Credit* ₹
Shri Banker's Capital Account	41,000	
Shri Banker's Drawing Account	6,100	
Mrs Banker's Loan Account		4,000
Sundry Creditors		45,000
Cash in Hand	250	
Cash at Bank	4,000	
Sundry Debtors	40,500	
Patents	2,000	
Plant and Machinery	20,000	
Land and Buildings	26,000	
Purchases of Raw Materials	35,000	
Raw Material as on 1.4.2016	3,500	
Work-in-process as on 1.4.2016	2,000	
Finished Stock as on 1.4.2016	18,000	
Carriage Inwards	1,100	
Wages	27,000	
Salary of Works Manager	5,600	
Factory Expenses	3,400	
Factory Rent and Taxes	2,500	
Royalties (paid on sales)	1,200	
Sales (*less* Returns)		1,23,400
Advertising	3,000	
Office Rent and Insurance	4,800	
Printing and Stationery	1,000	
Office Expenses	5,800	
Carriage Outwards	600	
Discounts	1,400	2,100
Bad Debts	750	
	2,15,500	2,15,500

The Stock on 31st March, 2017 was as follows:

₹4,000 Raw Materials, ₹4,500 Work-in-progress and ₹28,000 Finished Goods.

Solution:

MANUFACTURING ACCOUNT

for the year ending March 31, 2017

Particulars		₹	*Particulars*	₹
To Opening Work-in-process		2,000	By Transfer to Trading Account (cost of finished goods produced)	71,600
To Raw Materials used:				
Opening Stock	3,500		By Closing Work-in-process	4,500

NOTES

Particulars		₹	Particulars	₹
Add: Purchases	35,000			
	38,500			
Less: Closing Stock	4,000	34,500		
To Carriage Inwards		1,100		
To Wages		27,000		
To Salary of Works Manager		5,600		
To Factory Expenses		3,400		
To Factory Rent and Taxes		2,500		
		76,100		76,100

TRADING AND PROFIT & LOSS ACCOUNT
for the year ending March 31, 2017

Particulars	₹	Particulars	₹
To Opening Stock of Finished Goods	18,000	By Sales	1,23,400
To Manufacturing A/c (Cost of goods produced)	71,600	By Closing Stock of Finished Goods	28,000
To Gross Profit c/d	61,800		
	1,51,400		1,51,400
To Royalties	1,200	By Gross Profit b/d	61,800
To Advertising	3,000	By Discount received	2,100
To Office Rent and Insurance	4,800		
To Printing and Stationery	1,000		
To Office Expenses	5,800		
To Carriage Outwards	600		
To Bad Debts	750		
To Discount Allowed	1,400		
To Net Profit carried to Capital Account	45,350		
	63,900		63,900

BALANCE SHEET
as on 31st March, 2017

Particulars		₹	Particulars		₹
Sundry Creditors		45,000	Current Assets:		
Mrs. Banker's Loan		4,000	Cash in hand		250
Capital Account			Cash at Bank		4,000
Balance on			Sundry Debtors		40,500
1.4.2016	41,000		Closing Stock:		
Profit	45,350		Raw Materials	4,000	
	86,350		Work-in-process 4,500		
Less: Drawings	6,100	80,250	Finished goods 28,000		36,500
			Fixed Assets:		
			Patents		2,000
			Plant and Machinery		20,000
			Land and Buildings		26,000
		1,29,250			1,29,250

7.4.1 Treatment of Adjustments

Information given outside the trial balance are known as adjustments. It means journal entry of this adjustment has not been passed yet. Treatment of adjustments will be done keeping in mind the double entry system of book keeping .it means treatment of adjustments is done at least two places in final accounts to complete the double entry system of book-keeping. These adjustments relate to closing stock, outstanding expenses, prepaid expenses, outstanding or accrued income, etc., which have been discussed in detail in the previous unit.

Check Your Progress

5. Define marshalling.
6. What is the difference between Trial Balance and Balance Sheet on account of items covered?

7.5 PRACTICAL PROBLEMS

Practical Problems on Final Accounts without Adjustments

1. Prepare Manufacturing, Trading and Profit and Loss Account from the following figures relating for the year 2017:

	1.1.2017	*31.12.2017*
	₹	₹
Stock:		
Finished Goods	33,000	27,500
Raw Materials	16,000	18,300
Work-in-progress	11,100	9,400
Purchase of Materials		1,50,900
Carriage on Purchases		4,100
Wages		65,000
Factory Salaries		26,000
Office Salaries		18,000
Repair and Maintenance:		
Machinery		8,300
Office Equipment		1,700
Depreciation :		
Machinery		25,000
Office Equipment		8,100
Sundry Expenses :		
Factory		5,300
Office		17,800
Sales		3,60,000

It is the firm's practice to transfer goods from the Factory to Sales godown at cost plus 10%.

[**Ans.** Manufacturing Profit ₹28,400; Gross Profit ₹42,100; Net Loss ₹3,500]

2. From the following particulars, prepare Manufacturing Account, Trading Account, and Profit and Loss Account:

	₹
Purchases of Raw Materials	13,195
Return Inward	70
Stock on 31.12.2017	
Raw Materials	1,210

NOTES

Work-in-progress	1,000
Finished Goods	1,370
Productive Wages	2,000
Factory Expenses	1,840
General Office Expenses	300
Salaries	600
Distribution Expenses	100
Selling Expenses	700
Purchasing Expenses	600
Export Duty	300
Import Duty	200
Interest on Bank Loan	600
Stock on 1-1-2017	
Raw Material	400
Work-in-progress	300
Finished Goods	410
Sales	19,500
Returns Outward	85
Carriage Outward	105
Carriage Inward	100
Cash Discount (allowed)	10
Sale of scrap	20
Depreciation of Machinery	500
Repairs of Machinery	100
Depreciation of Office Furniture	40

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

3. From the following Trial Balance, prepare a Trading, Manufacturing and Profit and Loss Account and Balance Sheet as on 31st December, 2017:

TRIAL BALANCE

as on 31st December, 2017

Particulars	₹	₹
Stock on 1.1.2017		
Raw Materials	2,000	
Work-in-progress	5,000	
Finished Goods	10,000	
Manufacturing Wages	10,000	
Purchasing of Raw Materials	30,000	
Factory Rent	5,000	
Carriage of Raw Materials	3,000	
Salary of the Works Manager	2,000	
Office Rent	2,000	
Printing and Stationery	1,000	
Bad Debts	1,000	
Sales		60,000
Land and Buildings	30,000	
Plant and Machinery	20,000	
Depreciation on Plant	2,000	
Sundry Debtors	5,000	
Sundry Creditors		30,000
Cash in hand	5,000	
Capital		43,000
	1,33,000	1,33,000

Closing Stocks on 31st December, 2017 were as follows:

	₹
Raw Material	5,000
Work-in-process	4,000
Finished Goods	10,000

NOTES

[**Ans.** Cost of Production ₹50,000; Gross Profit ₹10,000; Net Profit ₹6,000; Total of Balance Sheet ₹79,000]

4. Prepare Manufacturing, Trading and Profit and Loss Account for the year ended 31st March, 2017 and Balance Sheet as at the end of the year from the following Trial Balance:

Particulars	₹	₹
Opening Stock of Raw Materials	30,000	
Opening Stock of Finished Goods	16,000	
Opening Stock of Work-in-progress	5,000	
Capital		72,000
Purchases of Raw Materials	2,50,000	
Sales		4,00,000
Purchases of Finished Goods	8,000	
Carriage Inwards	4,000	
Wages	50,000	
Salaries (75% Factory)	26,000	
Commission	3,000	
Bad Debt	2,000	
Insurance	4,000	
Rent, Rates and Taxes (50% Factory)	12,000	
Postage and Telegram	2,800	
Tea and Tiffin	1,600	
Travelling and Conveyance (25% Factory)	3,500	
Carriage Outwards	2,600	
Machinery	40,000	
Furniture	5,000	
Debtors	60,000	
Creditors		53,500
	5,25,500	5,25,500

The Closing Stocks are as follows:

Raw Materials	₹ 40,000
Work-in-progress	₹ 12,000
Finished Goods	₹ 8,000

[**Ans.** Cost of Production ₹3,13,375; Gross Profit ₹70,625; Net Profit ₹39,500; Balance Sheet Total ₹1,65,000]

5. From the following balances draw up a Trading and Profit and Loss Account and Balance Sheet:

Particulars	₹
P. Parikh Capital	20,000
Bank Overdraft	5,000
Machinery	13,400
Cash in Hand	1,000
Fixtures & Fittings	5,500
Opening Stock	45,000
Bills Payable	7,000

NOTES

Particulars	₹
Creditors	40,000
Debtors	63,000
Bills Receivable	5,000
Purchases	50,000
Sales	1,29,000
Returns from Customers	1,000
Returns to Creditors	1,100
Salaries	9,000
Manufacturing Wages	4,000
Commission and T.A.	5,500
Trade Expenses	1,500
Discount (Cr.)	4,000
Rent	2,200

The Closing Stock amounted to ₹52,000.

[**Ans.** Gross Profit ₹82,100; Net Profit ₹67,900 and Balance Sheet Total ₹1,39,900]

6. From the understated Trial Balance of M/s Suneel Brothers prepare (*a*) Manufacturing Account; (*b*) Trading and Profit and Loss Account; and (*c*) Balance Sheet:

TRIAL BALANCE
as on 31st December, 2017

Debit Balances	₹	*Credit Balances*	₹
Wages	20,000	Sales	1,74,000
Stock (Raw Materials)		Profit and Loss Balance 1.1.2017	12,000
1.1.2017	5,710	Capital	1,30,000
Purchases	88,274		
Carriage Inward	3,686		
Repairs	6,000		
Salaries (Factory)	2,100		
Salaries General	1,000		
Rates and Taxes	2,240		
Travelling Expenses	3,550		
Insurance (Factory)	700		
Insurance General	80		
Bad Debts	410		
General Expenses	2,942		
Carriage Outward	9,424		
Various Assets	1,13,884		
Stock 1.1.2017 (Finished Goods)	56,000		
	3,16,000		3,16,000

Closing Stock: Raw Materials, ₹5,272; Finished Goods, ₹34,324.

[**Ans.** Cost of Production, ₹1,21,198; Gross Profit ₹31,126; Net Profit ₹11,480; Balance Sheet Total ₹1,53,480]

7. The following are the Trading and Profit & Loss Account and Balance Sheet of *B* as on December 31, 2017. Redraw them in proper form, giving reasons for your correction.

TRADING AND PROFIT & LOSS ACCOUNT
for the year ended 31.12.2017

Particulars	₹	*Particulars*	₹
Purchases	4,66,800	Sales	5,59,900
Stock	55,110	Profit on Consignment to	
Salaries	11,010	*A* & Co., Bombay	19,080
B's Drawings	19,170	Interest on Capital	7,500
Wages	65,590	Stock (1st Jan.)	50,310
Rent	2,250	Commission received	27,990
General Expenses	17,470	Discount received	11,250
Interest on Loan	3,000		
Bad Debts	11,890		
Net Profit to *B/S*	23,740		
	6,76,030		6,76,030

BALANCE SHEET
as on 31.12.2017

Liabilities	₹	*Assets*	₹
Creditors	1,95,070	Debtors	2,61,580
Bills Receivable	1,30,140	Cash	960
Capital (1.1.2017)	1,50,000	Bank	52,210
Net Profit from *P&L* A/c	23,740	Loan from Bank	75,000
		Stock (31-12-2017)	55,110
		Bills Payable	54,090
	4,98,950		4,98,950

[**Ans.** Gross Profit ₹32,310; Net Profit ₹37,510; Balance Sheet Total ₹5,00,000]

Practical Problems on Final Accounts with Adjustments (discussed in Unit 6)

8. State how the following must be dealt with in the final accounts of a firm for the year ended 31.12.2016 giving reasons in brief:

(*i*) Adverstisement expenditure of ₹10,000 paid on 30.12.2016, the adverstisement in respect of which has appeared in the magazines only in January, 2016.

(*ii*) Cost of temporary pandal erected for an exhibition on 1.7.2016, the exhibition being expected to be over by June 2016: ₹17,000.

(*iii*) Cost of a second-hand scooter purchased on 1.10.2016 for ₹2,500, which was totally destroyed in an accident on 31.11.2016, the insurance company paying ₹1,000 in full settlement in January, 2016.

(*iv*) Petrol expenses of ₹420 paid for the car of one of the partners for an official visit, the car not being an asset of the firm.

(*v*) Hire charges of ₹1,000 for a compressor, when the firm's own compressor was under breakdown.

[**Ans.** (*i*) Prepaid expense; (*ii*) Charge ₹8,500 to *P* & *L* in 2016 and carry forward the balance to 2017; (*iii*) Write off ₹1,500 from *P* & *L*; (*iv*) Charge *P* & *L* A/c as a travelling expense] (*v*) Charge Manufacturing A/c (if prepared) or *P* & *L* A/c]

9. (*a*) On Ist January, 2017 the Provision for Doubtful Debts Account in the books of a firm which maintains it at 5% had a credit balance of ₹1,100. During the year the Bad Debts amounted to ₹800 and the debtors at the end of the year were ₹20,000. Show Provision for Doubtful Debts Account and Bad Debts Account for the year 2017.

(*b*) At the end of an accounting year, a trader finds that no entry has been passed in the books of accounts in respect of the following transactions:

(*i*) Outstanding salary at the end of the year ₹200.

(*ii*) Goods given as charity during the year ₹300.

(*iii*) Stock-in-hand at the end of the year ₹20,000. Journalise these transactions.

10. The following balances were taken from the records of a firm. For each account give the adjusting journal entry which may have resulted in the change in that account balance.

NOTES

Particulars	*Trial Balance*	*Adjusted Trial Balance*
Advance from Customers	20,000	16,000
Prepaid Insurance	8,000	6,000
Wages Payable	3,000	5,000
Interest (Credit Balance)	1,000	1,200
Accumulated Depreciation	15,000	20,000

Assume that the final accounts were prepared from the unadjusted balances. How would the Profit and Loss account and Balance Sheet be affected in each of the above cases?

11. The following items are found in the Trial Balance of John on 31st December, 2017:

	₹
Debtors	16,000
Bad Debts	300
Bad and Doubtful Debts Provision 1.1.2017	700

You are to provide for the bad and doubtful debts @ 5%. Give the necessary journal entries and prepare the Bad Debts Account, Bad and Doubtful Debts Provision Account, Profit and Loss Account, Sundry Debtors Account in the ledger and a Balance Sheet appearing after the final adjustments.

12. A firm had the following Balances on Ist January, 2017:

	₹
(*a*) Provision for Bad and Doubtful Debts	2,500
(*b*) Provision for Discount on Debtors	1,200
(*c*) Provision for Discount on Creditors	1,000

During the year Bad Debts amounted to ₹2,000, Discounts allowed were ₹100 and Discounts received were ₹200. During 2018 Bad Debts amounting to ₹1,000 were written off while Discounts allowed and received were ₹2,000 and ₹500 respectively.

Total Debtors on December, 31, 2017 were ₹48,000 before writing off Bad Debts, but after allowing Discounts. On December 31, 2018 the amount was ₹19,000 after writing off the Bad Debts but before allowing Discounts. Total Creditors on these two dates were ₹20,000 and ₹25,000 respectively.

It is the firm's policy to maintain a provision of 5% against Bad and Doubtful Debts and 2% for Discount on Debtors and a provision of 3% for Discount on Creditors.

Show the accounts relating to Provision on Debtors and Provision on Creditors for the year 2017 and 2018.

[**Ans.** Balances on 31.12.2017 Bad Debts Provision ₹850; Provision for Discount on Debtors ₹323; and Provision for Discount on Creditors ₹750]

7.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The profit disclosed by the Trading Account is termed as Gross Profit.
2. The closing stock is valued on the basis of 'cost or market price which is less' principle.
3. 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.

4. 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.
5. Marshalling refers to arrangement of assets and liabilities in the balance sheet in any of the following order: liquidity order and permanency order.
6. 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.

7.7 SUMMARY

- 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 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.

NOTES

- 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.
- Important things to be considered while preparing Profit and Loss Account are: gross profit and loss, salaries, salaries less tax, interest, commission, trade expenses, bad debts, printing and stationery, depreciation, discount, commissions, etc.
- Having prepared the Manufacturing, 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''. It is 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.
- There is no prescribed form of Balance Sheet for a sole proprietary and partnership firm. 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.
- Important points to consider while preparing a Balance Sheet are the types and valuations of liabilities and assets.

7.8 KEY WORDS

- **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.

7.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What is merchandise?
2. List the equations required for preparing the Trading Account.
3. Explain the importance of Trading Account.
4. What are the important information provided by the Profit and Loss Account?
5. Distinguish between Profit and Loss Account and Balance Sheet.

Long Answer Questions

1. Discuss the important points regarding Trading Account.
2. Examine the important points to be kept in mind while preparing a Profit and Loss Account.
3. Illustrate the different forms of Marshalling.
4. Discuss the differences between Trial Balance and Balance Sheet.
5. What are the important points regarding the preparation of Balance Sheet.

NOTES

7.10 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 8 BANK RECONCILIATION STATEMENT

NOTES

Structure

8.0 Introduction
8.1 Objectives
8.2 Meaning, Importance and Procedure of Reconciliation
8.2.1 Reasons for Difference
8.2.2 Meaning and Importance of Bank Reconciliation Statement
8.2.3 Technique or Procedure of Preparing Bank Reconciliation Statement
8.3 Answers to Check Your Progress Questions
8.4 Summary
8.5 Key Words
8.6 Self Assessment Questions and Exercises
8.7 Further Readings

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, IMPORTANCE 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

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

NOTES

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.

8.2.3 Technique or Procedure of Preparing 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.

(*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.

NOTES

(*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.

Solution:

BANK RECONCILIATION STATEMENT

(as on 31st December, 2017)

NOTES

	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.

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:

(*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	

(*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.

NOTES

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?

8.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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.

8.4 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.

8.5 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.

8.6 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.

8.7 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.

BLOCK - III

PARTNERSHIP ACCOUNTS

NOTES

UNIT 9 BILLS OF EXCHANGE

Structure

9.0 Introduction
9.1 Objectives
9.2 Bills of Exchange: Fundamental Concepts
9.3 Recording of Bill of Exchange in the Books of Account
9.4 Answers to Check Your Progress Questions
9.5 Summary
9.6 Key Words
9.7 Self Assessment Questions and Exercises
9.8 Further Readings

9.0 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].

9.1 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
- Recall the concepts of acceptance of a bill and due date
- Describe the recording of Bill of Exchange in the book of Accounts

[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.

9.2 BILLS OF EXCHANGE: FUNDAMENTAL CONCEPTS

NOTES

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.

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.

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."

NOTES

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.

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?

9.3 RECORDING OF BILL OF EXCHANGE IN THE BOOKS OF ACCOUNT

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.

NOTES

(*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

NOTES

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

NOTES

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

5. Renewal of a Bill

NOTES

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.)

NOTES

(*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.)

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:

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)

NOTES

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

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 9.1. *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.

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 9.2. *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

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 9.3. 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 9.4. 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.

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.

NOTES

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 9.5. 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.

9.4 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	

9.5 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.
- 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.

9.6 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.

9.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

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

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.

9.8 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 10 PARTNERSHIP ACCOUNTS

NOTES

Structure

10.0 Introduction
10.1 Objectives
10.2 Partnership: Meaning, Features, Deed and Contents
10.3 Admission of a Partner
10.4 Answers to Check Your Progress Questions
10.5 Summary
10.6 Key Words
10.7 Self Assessment Questions and Exercises
10.8 Further Readings

10.0 INTRODUCTION

Partnership form of business organisation came into existence on account of limitations of sole proprietary concerns. The major limitations of sole proprietary concerns are those of shortage of funds, uncertainty about existence, unlimited personal liability etc. In case of a partnership business two or more persons join hands together to do a business. Thus, the risk, funds, responsibility all are shared. The Indian Partnership Act, 1932 is applicable to contracts of Partnership. According to Section 4 of the said Act partnership is "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all". Persons who have entered into partnership with one another are called individually 'partners' and collectively a 'firm' and the name under which the business is carried on is called the 'firm's name'.

The term 'firm' is merely a commercial notion. Law does not invest the firm with legal personality apart from its partners except for the purposes of assessment of income-tax. A 'firm' cannot become a member of another partnership firm though its partners can join any other firm as partners.

It may be noted that under the Limited Partnership Act 2008, a limited liability partnership can be formed as a body corporate having a separate legal entity.

10.1 OBJECTIVES

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

- Discuss the concept of partnership in financial accounting
- Describe the features of partnership
- Explain the meaning of partnership deed and related contents

NOTES

- Examine the accounting entry admission of a partner
- Identify the accounting entries in case of goodwill, revaluation of assets and reserves
- Recall the adjustments of reserves and accumulated profits and losses in partnership accounts

10.2 PARTNERSHIP: MEANING, FEATURES, DEED AND CONTENTS

A partnership business must satisfy all the following essential elements. They must exist together. Absence of any one of them may cut the roots of partnership.

1. **There must be an association of two or more persons** A person cannot become a partner with himself. Reduction in the number of partners to one shall bring about compulsory dissolution of the firm. The term 'person' does not include 'firm' (since it does not have a separate legal existence) and as such only the partners of the firms can enter into partnership provided the combined strength of partners does not exceed the statutory limit. According to section 464 of the Companies Act 2013, the number of partners in partnership firm should not exceed such numbers as may be presented. At present it has been prescribed as 50 which shall not exceed 100. An association or a partnership firm having members more than this statutory limit must be registered as a joint stock company, under the Companies Act or formed in pursuance of some other Indian law, otherwise it shall become an illegal association.
2. **There must be an agreement entered into by all persons concerned** The relation of partnership arises from contract and not from status or by operation of law. Partners must enter into an agreement voluntarily to form a partnership. The agreement may be express or implied. It may be for a fixed period or for a particular venture or at will, *i.e.*, for an uncertain duration. Co-owners of a property or heirs of a sole proprietor who has died will not *ipso facto* become partners in the business, unless there is an agreement between them to carry on business as partners.

   Partners must enter into the contract with a motive to earn and distribute amongst themselves profits of the business. Agreement to share losses is not essential. Agreement to share profits also implies an agreement to share losses.
3. **Business must be carried on by all or any of the persons concerned acting for all** Partners in a firm act in both the capacities of an agent

as well as principal. Active partners act as agents and conduct the business for all the partners under an implied authority to do so by the latter. Partners are mutual agents for each other and principals for themselves. A partner has an authority to bind his co-partners by his acts done in the ordinary course of the business of the firm. Partner's liability is not limited to his share in the business but it extends to his personal assets too.

Partnership Deed

Partnership is created by an agreement. It is not necessary that the agreement should be in writing. It may be oral but to avoid future disputes it is always better to have it in writing. The document in writing containing the important terms of partnership as agreed by the partners between themselves is called the *Deed of Partnership*. It should be properly drafted and stamped according to the provisions of The Stamp Act.

Contents of the Deed

The deed usually contains the following information:

1. Name of the firm.
2. Names of partners.
3. Nature and place of the business of the firm.
4. Date of commencement of partnership.
5. Duration of the firm.
6. Capital employed or to be employed by different partners.
7. Rules regarding operation of bank accounts.
8. Ratios in which profits and losses are to be shared.
9. How the business is to be managed?
10. Rules to be followed in case of admission, retirement, expulsion etc., of a partner.
11. Salaries etc., if payable to partners.
12. Interest on partners' capitals, loans, drawings etc. to be allowed or charged.
13. Settlement of accounts on the dissolution of the firm.
14. Arbitration clause.

It is better if the deed is very elaborate and clear about all questions which may arise in the course of partnership. In the absence of any agreement the rights and duties of partners will be those which have been given in the Partnership Act.

NOTES

Provisions Affecting Accounting Treatment

The partnership deed is usually very elaborate. It covers all matters affecting the partnership business. However, *in the absence of any provision to the contrary in the partnership deed/agreement*, the following provisions govern the accounting treatment of certain items:

1. **Right to share profits** Partners are entitled to share equally in the profits earned and to contribute equally to losses incurred.
2. **Interest on capital** No interest is payable on the capitals contributed by them. Similarly no interest is to be charged on drawings. However, where partnership agreement provides for payment of interest on capital, such interest is payable out of profits of the business unless otherwise provided.
3. **Interest on advances** A partner who makes an advance of money to the firm beyond the amount of his capital for the purpose of business, is entitled to get interest thereon at the rate of 6% p.a.
4. **Right to share subsequent profits after retirement** Where any member of a firm has died or otherwise ceased to be a partner and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them, the outgoing partner or his estate is entitled, at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of six per cent per annum on the amount of his share in the property of the firm.
5. **No remuneration for firm's work** A partner is required to attend diligently to his duties in conducting the business of the firm. He has no right to receive remuneration or salary for taking part in the conduct of the business.

Check Your Progress

1. What is the maximum limit of partners in a partnership firm as per the Companies Act, 2013?
2. State the provision for interest on advances when there is no specified provision in the partnership deed.

10.3 ADMISSION OF A PARTNER

Any change in the relations of the partners will result in the reconstitution of a partnership firm. The firm is, therefore, said to be reconstituted when there is admission, retirement or death of a partner or where a partnership firm gets amalgamated with another partnership firm. In the present section, the accounting entries relating to admission of a partner are being explained.

NOTES

Admission of a Partner

Section 31 of the Partnership Act deals with the statutory provisions regarding admission of a new partner. These provisions are summarised below:

(*i*) A new partner cannot be admitted without the consent of all the partners unless otherwise agreed upon.

(*ii*) A new partner admitted to an existing firm, is not liable to any debts of the firm incurred, before he comes in as a partner. The new partner cannot be held responsible for the acts of the old partners unless it is proved that:

- (*a*) the reconstituted firm has assumed the liability to pay the debt; and
- (*b*) that the creditor concerned has agreed to accept the reconstituted firm as his debtor and to discharge the old firm from liability.

However, a minor admitted to the benefits of partnership, who, if he elects to become a partner in the firm after attaining majority, shall become personally liable for all the acts of the firm done since he was admitted to the benefits of partnership.

A newly admitted partner shall be liable only for the debts incurred or transactions entered into by the firm subsequent to his becoming a partner.

Accounting Problems

The accounting problems on admission of a new partner can be put as follows:

(*i*) Adjustment in the profit sharing ratio.

(*ii*) Adjustment for goodwill.

(*iii*) Adjustment for revaluation of assets and liabilities.

(*iv*) Adjustment for reserves and other accumulated profits.

(*v*) Adjustment for capital.

Each of the above problems are being discussed in the following pages.

Adjustment in the Profit Sharing Ratio

A newly admitted partner will be entitled to share the profits or bear the losses with the other partners. Hence, the profit sharing ratio of the partners will change. There can be two situations.

1. The new partner may be given a certain proportion of the total profit or required to bear a certain proportion of the total loss and the old

NOTES

partners continue to share the balance of profit or bear the balance of loss in the old ratio in between themselves.

Illustration 10.1. *A* and *B* are partners in a business sharing profits and losses in the ratio of 3:2. They admit a new partner *C* with 1/5 share in the profits. Calculate the new profit sharing ratio of the partners.

Solution:

C's share is 1/5 of the total profit. Thus, for *A* and *B* the remaining profit is only 4/5 (*i.e.,* 1 – 1/5).

A and *B* continue to share profits in old ratio.

The shares of the two partners will therefore be:

$A \quad \frac{4}{5}\times\frac{3}{5}=\frac{12}{25} \qquad B \quad \frac{4}{5}\times\frac{2}{5}=\frac{8}{25}$

Thus the new profit sharing ratio is

A		B		C
$\frac{12}{25}$	:	$\frac{8}{25}$	:	$\frac{1}{5}$
or 12	:	8	:	5

Illustration 10.2. *A* and *B* share profits in the ratio of 3 : 2. They admit *C* with 1/5 share in the profits, which he gets equally from *A* and *B*. Calculate the new profit sharing ratio.

Solution:

C's share is 1/5 of total profits. He gets it equally from A and *B* *i.e.* $\frac{1}{5}\times\frac{1}{2}=\frac{1}{10}$ from *A* and $\frac{1}{5}\times\frac{1}{2}=\frac{1}{10}$ from *B*.

A's share of profit will therefore be:

$$\frac{3}{5}-\frac{1}{10}=\frac{6-1}{10}=\frac{5}{10}$$

B's share of profit will therefore be:

$$\frac{2}{5}-\frac{1}{10}=\frac{4-1}{10}=\frac{3}{10}$$

Thus, the new profit sharing ratio is:

A		B		C
$\frac{5}{10}$	:	$\frac{3}{10}$	:	$\frac{1}{5}$
or 5	:	3	:	2

Illustration 10.3. *A* and *B* are partners sharing profits in the ratio of 7 : 3. *A* surrenders1/7 of his share and *B* surrenders 1/3 of his share in favour of *C*, the new partner. What is the new ratio and what is the sacrificing ratio?

Solution:

Old Profit sharing ratio

A : *B*

7 : 3

Surrender by *A*: $\frac{7}{10}\times\frac{1}{7}=\frac{7}{70}$

Surrender by *B*: $\frac{3}{10}\times\frac{1}{3}=\frac{3}{30}$

New Ratio:

$$A: \quad \frac{7}{10}-\frac{7}{70}=\frac{49-7}{70}=\frac{42}{70}=\frac{6}{10}$$

$$B: \quad \frac{3}{10}-\frac{3}{30}=\frac{9-3}{30}=\frac{6}{30}=\frac{1}{5}$$

$$C: \quad \frac{7}{10}+\frac{3}{30}=\frac{1}{10}+\frac{1}{10}=\frac{2}{10}$$

New Ratio:

A: $\frac{6}{10}$, B: $\frac{1}{5}$, C: $\frac{2}{10}$,

or	12	:	4	:	4
or	3	:	1	:	1

NOTES

Adjustment for Goodwill

Since the new partner gets a share in the profits of the firm, he should compensate the old partners for sharing the earning of the firm on account of the reputation or goodwill earned by the partnership firm so far.

The problem of goodwill on admission of a new partner can be dealt in two different ways:

1. When the goodwill account already appears in the books.
2. When the goodwill account is not appearing in the books at the time of admission of a partner.

If the goodwill account is already appearing in the books There can be three situations:

(*i*) The goodwill account is appearing at a proper value. In such an event no adjustment will be required for goodwill.

Illustration 10.4. *A* and *B* are sharing profits in the ratio 3 : 2. They admit a new partner *C* with 1/5 share in the profits. At the time of admission of *C*, goodwill is appearing in the firm's books at ₹10,000 and it is agreed by all partners (including *C*) that it is properly valued. Should *C* pay anything for goodwill?

NOTES

Solution:

Since goodwill is already appearing in the books, it shows that the old partners have already got credit to their capital accounts with the value of goodwill. Moreover, it is properly valued and hence *C* will not be required to pay anything for goodwill nor any further adjustment will be required.

(*ii*) The goodwill account is to be revalued. In such an event entry will be made only with the difference. The amount of over or under-valued goodwill is debited or credited to the old partners in the old ratio and credited or debited to goodwill account.

Illustration 10.5. With the information given in Illustration 10.4, pass the necessary journal entry if the goodwill is agreed to be valued at ₹15,000 on *C*'s admission.

Solution:

Goodwill A/c	Dr.	5,000	
To *A*'s Capital A/c			3,000
To *B*'s Capital A/c			2,000
(Being value of goodwill raised by ₹5,000)			

(*iii*) Sometimes adjustment may have to be made for undisclosed goodwill. This happens when goodwill account is already appearing in the books but the new partner is required to bring premium for sharing future profits of the firm. In such an event the goodwill brought in by the new partner will be utilised as basis for revaluation of goodwill.

Illustration 10.6. *A* and *B* are partners sharing profits in the ratio of 3 : 2. Goodwill appears in the books at ₹4,000. *C* is admitted as a partner and pays ₹1,000 as premium for 1/5 share of the profits of the firm. Journalise the above transaction presuming that the profit sharing ratio between *A* and *B* remains unchanged.

Solution:

The question can be solved by taking any of the following two presumptions:

(*i*) Goodwill account is not to be disturbed.

(*ii*) Goodwill account is to be disturbed.

Where goodwill account is not to be disturbed

As *C* is acquiring 1/5 share of goodwill for ₹1,000 the whole goodwill is ₹5,000, of which ₹4,000 already appears in the books. Hence, the value of undisclosed goodwill is ₹1,000 and *C*'s share, thereof is ₹200. This amount should be debited to his capital account and credited to *A* and *B* in the ratio

NOTES

in which they sacrifice on account of admission of *C*. The amount of ₹1,000 brought in by *C*, should then be credited to his capital account. *C*'s account thus gets a credit of ₹800. The journal entries will be:

	Particulars		Dr. (₹)	Cr. (₹)
	C's Capital A/c	Dr.	200	
	To *A*'s Capital A/c			120
	To *B*'s Capital A/c			80
	(Being premium charged to *C* for 1/5 share of the undisclosed goodwill)			
	Bank A/c	Dr.	1,000	
	To *C*'s Capital A/c			1,000
	(Being payment by *C* of the premium for 1/5 share of the goodwill)			

In case, on dissolution of the firm the goodwill realises ₹5,000, *C* will get ₹200 (*i.e.*, 1/5 of ₹1,000) out of the profit on account of sale of goodwill.

Thus, he is compensated for ₹200 with which he was charged on his admission.

When goodwill account is to be disturbed

There could be two alternatives:

(*a*) The increase or decrease in the value of the goodwill be debited or credited to old partners capital accounts in the old ratio. The entire premium brought in by the new partner may be credited to his capital account.

The following journal entries will be passed in such a case on basis of information given in Illustration 10.6.

	Particulars		Dr. (₹)	Cr. (₹)
	Goodwill A/c	Dr.	1,000	
	To *A*'s Capital A/c			600
	To *B*'s Capital A/c			400
	(Being goodwill revalued)			
	Bank A/c	Dr.	1,000	
	To *C*'s Capital A/c			1,000
	(Premium brought in by *C* credited to his capital account)			

Thus, *C* has not paid anything to *A* and *B* for goodwill because goodwill has now been revalued on his admission and *A* and *B* have got due credit for it.

(*b*) The old goodwill may be written off and charged to old partners in the old ratio. Cash brought in by *C* should be credited to the old partners in their sacrificing ratio. Goodwill account is then raised at the new value and credit is given to all the partners in their new ratio. The journal entries will be as follows:

NOTES

	Particulars		Dr. (₹)	Cr. (₹)
	A's Capital A/c	Dr.	2,400	
	B's Capital A/c	Dr.	1,600	
	To Goodwill A/c			4,000
	(Being goodwill account written off)			
	Bank	Dr.	1,000	
	To *A*'s Capital A/c			600
	To *B*'s Capital A/c			400
	(Cash brought in by *C* for goodwill being credited to *A* and *B*)			
	Goodwill A/c	Dr.	5,000	
	To *A*'s Capital A/c			2,400
	To *B*'s Capital Ale.			1,600
	To *C*'s Capital A/c			1,000
	(Goodwill account raised)			

The net affect of these entries is the same as given in case of alternative (*a*), discussed above.

When the goodwill account is not appearing in the books There can be several alternatives.

(*i*) The new partner may bring cash for his share of goodwill. The amount so brought in by the new partner will be credited to the old partners in the ratio in which they sacrifice on admission of the new partner.

Illustration 10.7. *A* and *B* are sharing profits equally. They admit a new partner *C* with 1/5 share in profits. The new profit sharing ratio being 2 : 2 : 1. The value of firm's goodwill is ₹10,000. *C* brings his share of goodwill in cash. Pass the necessary journal entry.

Solution:

A and *B* were sharing profits in the ratio of 1/2 and 1/2.

Under the new agreement *A* gets 2/5 and *B* gets 2/5.

Thus, sacrifice made by *A* and *B* is equal:

$$A \qquad \frac{1}{2}-\frac{2}{5}=\frac{5-4}{10}=\frac{1}{10}$$

$$B \qquad \frac{1}{2}-\frac{2}{5}=\frac{5-4}{10}=\frac{1}{10}$$

The amount of goodwill ₹2,000 (*i.e.*, l0,000 × 1/5) will, therefore, be shared by *A* and *B* equally. The journal entry will be:

	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	2,000	
	To *A*'s Capital A/c			1,000
	To *B*'s Capital A/c			1,000
	(Being goodwill brought in by *C*)			

Alternatively, the amount brought in cash for goodwill by the new partner be credited to the goodwill account. It may then be transferred to old partners' capital accounts in the sacrificing ratio. However, the method is not preferable to the one discussed above.

The journal entries in such a case would be:

	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	2,000	
	To Goodwill A/c			2,000
	(Being amount of goodwill brought in by the new partner)			
	Goodwill A/c	Dr.	2,000	
	To *A*'s Capital A/c			1.000
	To *B*'s Capital A/c			1,000
	(Goodwill distributed among the old partners)			

NOTES

Another alternative could be to credit the new partner's capital account with the cash brought in by him for capital and goodwill. A goodwill account is raised in the books with full value and the amount is credited to the old partners in the old profit sharing ratio. The goodwill account is then written off to all partners in the new profit sharing ratio.

Illustration 10.8. *A* and *B* are two partners sharing profits in the ratio of 3 : 2. They admit a new partner *C*. The new ratio being 2 : 2 : 1 for *A*, *B* and *C* respectively. *C* brings ₹10,000 as capital and ₹5,000 as goodwill. Pass the necessary journal entries.

Solution:

JOURNAL

	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	15,000	
	To *C*'s Capital A/c			15,000
	(Being the amount of goodwill and capital brought in by *C*)			
	Goodwill A/c	Dr.	25,000	
	To *A*'s Capital A/c			15,000
	To *B*'s Capital A/c			10,000
	(Being goodwill account raised)			
	A's Capital A/c	Dr.	10,000	
	B's Capital A/c	Dr.	10,000	
	C's Capital A/c	Dr.	5.000	
	To Goodwill			25,000
	(Being goodwill account written off)			

The amount brought in by new partner for goodwill may be either wholly or partly withdrawn by the old partners. For example, if in the Illustration 10.7 *A* and *B* withdraw in cash 50% of the amount of goodwill brought in by *C*, the accounting entry will be:

	Particulars		Dr. (₹)	Cr. (₹)
	A's Capital A/c	Dr.	500	
	B's Capital A/c	Dr.	500	
	To Bank			1,000
	(Being 50% goodwill brought in cash withdrawn)			

(*ii*) A goodwill account may be raised in the books. In such an event the new partner will not bring any cash for his share of goodwill. The goodwill so raised will be credited to the old partners in their old profit sharing ratio.

NOTES

Illustration 10.9. *A* and *B* are sharing profits in a business in ratio of 3 : 2. They admit *C* as a partner. The new ratio being 2 : 2 : 1 for *A*, *B* and *C* respectively. The value of the firm's goodwill is estimated at ₹15,000. *C* is not in a position to bring any cash for his share of goodwill. Pass a suitable journal entry for adjustment of goodwill in the partners' capital accounts.

Solution:

	Particulars		Dr. (₹)	Cr. (₹)
	Goodwill A/c	Dr.	15,000	
	To *A*'s Capital A/c			9,000
	To *B*'s Capital A/c			6,000
	(Being goodwill account raised)			

(*iii*) The new partners may not like to continue with the goodwill account in the firm's books. In such an event the goodwill account which was raised on admission of a partner, will be written off among all the partners in the new profit sharing ratio.

Illustration 10.10. With the information given in Illustration 10.9 state the journal entries to be passed when the partners first decide to raise the goodwill account and subsequently decide to write it off.

Solution:

JOURNAL

	Particulars		Dr. (₹)	Cr. (₹)
	Goodwill A/c	Dr.	15,000	
	To *A*'s Capital A/c			9,000
	To *B*'s Capital A/c			6,000
	(Being goodwill account raised)			
	A's Capital A/c	Dr.	6,000	
	B's Capital A/c	Dr.	6,000	
	C's Capital A/c	Dr.	3,000	
	To Goodwill A/c			15,000
	(Being goodwill account written off)			

(*iv*) The partners may desire to make adjustment for goodwill without raising the goodwill account at all. In such an event the following entry may be passed on the basis of data given in Illustration 10.9.

	Particulars		Dr. (₹)	Cr. (₹)
	C's Capital A/c	Dr.	3,000	
	To *A*'s Capital A/c			3,000

C has been debited because he gets 1/5 share in the profits and the entire sacrifice has been made by *A*.

(*v*) The new partner may be in a position to pay cash only for a part of his share of goodwill. In such an event the amount received as premium will be credited to the old partners in their sacrificing ratio and for the balance of his share, a goodwill account will be raised in the firm's books.

Illustration 10.11. *X, Y* and *Z* were partners sharing profits and losses as to *X* one-half, *Y* one-third and Z one-sixth. As from January 1, 2016, they agreed to admit *A* into partnership for a one-sixth share in profits and losses, which he acquired equally from *X* and *Y*, and he agreed to bring in ₹20,000 for his capital and ₹10,000 as premium for goodwill. *A* paid in his capital money but in respect of premium for goodwill he could bring in only ₹5,000 and in regard to the unpaid amount he agreed to the raising of goodwill account in the books of the new firm as would be appropriate in the circumstances.

You are requested to:

(*i*) give the Journal entries to carry out the above arrangements, and

(*ii*) work out the new profit sharing ratio of the partners.

Solution: (*i*)

JOURNAL ENTRIES IN RECONSTITUTED PARTNERSHIP FIRM'S BOOKS

(as on January 1, 2016)

	Particulars		*Dr.* (₹)	*Cr.* (₹)
	Cash	Dr.	25,000	
	To *A*'s Capital A/c			25,000
	(Introduction of ₹25,000 by incoming member *A* into the firm)			
	A's Capital	Dr.	5,000	
	To *X*'s Capital			2,500
	To *Y*'s Capital			2,500
	(Payment for goodwill credited in the sacrificing ratio to old partners)			
	Goodwill	Dr.	30,000	
	To *X*'s Capital A/c			15,000
	To *Y*'s Capital A/c			10,000
	To *Z*'s Capital A/c			5,000
	(Raising of 50% of goodwill)			

or *X, Y, Z* and *A*'s new profit sharing ratio is 5 : 3 : 2 : 2 respectively.

Goodwill to be inferred Sometimes the value of goodwill has to be inferred on the basis of total capital of the firm.

Illustration 10.12. *A* and *B* are equal partners in a partnership firm with capitals of ₹14,000 each. They admit a new partner *C* in the firm with 1/4 share in the profits of the firm. *C* is to bring ₹12,000 as his capital. No Goodwill account, at present, appears in the books of the firm. Pass the necessary journal entry for Goodwill in the books of the firm.

Solution:

Since *C* is required to bring ₹12,000 as capital for 1/4 share in the profits of the firm, the total capital of the firm would be taken as ₹48,000. The total capital of the partners (including *C*) now stands at ₹40,000. It means ₹8,000 is hidden goodwill which should be credited to old partners in their old profit sharing ratio. The following journal entry would therefore be passed in the books of the firm;

	Particulars	Dr. (₹)	Cr. (₹)
	Goodwill A/c Dr.	8,000	
	To *A*'s Capital A/c		4,000
	To *B*'s Capital A/c		4,000
	(Being goodwill inferred on admission of *C*)		

NOTES

AS 10, AS 26, Ind AS 38 and Goodwill

We have discussed in the preceding pages the traditional methods adopted in popular textbooks for treatment of Goodwill. However, these methods should be adopted keeping in view the treatment of intangible Goodwill, an intangible asset as given Accounting Standards 10, 26 and Ind AS 38.

The provisions of AS 10 and AS 26 arc as under:

1. **AS 10: Accounting for Fixed Assets.** Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess should be termed as "goodwill" (*Para 36*).
2. **AS 26: Intangible Assets.** Internally generated goodwill should not be recognised as an asset. (*Para 35*). Such goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost (*Para 36*).
3. **Ind AS 38: Intangible Assets.** An intangible asset shall be recognized if, and only if:
   (*a*) It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
   (*b*) The cost of the asset can be measured reliably (*Para 21*).

Hence, Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. In other words no goodwill account should be raised in case of internally generated goodwill, either because of no cost being incurred or its cost is not capable of being measured reliably.

It may, therefore, be preferable for a partnership firm to adopt the following treatment for goodwill in case of admission of a partner.

(*i*) *When the required amount of goodwill is brought in by the incoming partner*

In the above case, the amount of goodwill brought in by the incoming partner is shared by the old partners in their sacrificing ratio. The Journal entry will be as follows:

Bank Account Dr.

To Old Partners' Capital A/cs

(In the sacrificing ratio)

(*ii*) *When the required amount of goodwill brought in by the new partner is immediately withdrawn by the partners*.

NOTES

In the above case the amount of goodwill is withdrawn by the partners in the sacrificing ratio and the entry for withdrawal will be:

Old Partners' Capital (A/cs) Dr.

To Bank A/c

(*iii*) *Where the new partner pays amount of goodwill privately to the old partners*

In this case, no entry should be passed in the books of the Arm. The amount to be paid to each partner should be calculated as per the profit-sacrificing ratio.

(*iv*) *Where the new partner is unable to bring anything for goodwill*

In this case, the value of goodwill should not be raised in the books. It is inherent goodwill, hence it is preferable that such value of goodwill should be adjusted through partners' capital accounts. The new partner's capital account should be debited with this share of goodwill and the amount should be credited to old partners' capital accounts in the ratio in which they make sacrifice of profits. The journal entry should be:

New Partner's Capital A/c Dr.

To Old Partners' Capital A/cs

In place of adjusting the value of goodwill of the firm through partners' capital accounts, another practice is also followed without keeping goodwill account in the books. In this case goodwill account is raised in the books by crediting the value of goodwill to old partners' capital accounts in old profit sharing ratio and then writing off the value of goodwill by debiting all partners' capital accounts in the new profit sharing ratio.

(*v*) *When the new partner brings a portion of the required amount of goodwill*

In such a case, the amount brought in by the new partner should be shared by the old partners in the sacrificing ratio and the portion of amount of goodwill not brought in by the new partner should be adjusted through the capital accounts of partners by debiting new partner's capital account with the amount and crediting the old partners' capital accounts in their sacrificing ratio.

Adjustment for Revaluation of Assets and Liabilities

NOTES

The assets and liabilities may have to be revalued on admission of a partner so that the profit or loss on account of improper valuation of the assets or liabilities is shared or borne only by the old partners. The adjustment can be done in two ways:

When assets and liabilities have to appear in the books at the revised values

In such a case a Profit and Loss Adjustment Account or Revaluation Account is opened in the books. The following entries are to be passed.

(*i*) For increase in the value of an asset or decrease in the value of a liability.

Asset/Liability A/c Dr.

To *P* & *L* Adjustment A/c

(*ii*) For decrease in the value of an asset or increase in the value of a liability.

P & *L* Adjustment A/c Dr.

To Asset/Liability A/c

(*iii*) The profit on revaluation will be transferred to old partners' capital accounts in the old profit sharing ratio.

P & *L* Adjustment A/c Dr.

To Old Partners Capital A/cs (Individually).

In the event of loss, the entry will be reversed.

When assets and liabilities have to appear at old values in the books

A Memorandum Profit and Loss Adjustment Account will be opened in the books. The increase in the value of assets or decrease in the value of liabilities will be credited to this account. The decrease in the value of assets or increase in the value of liabilities will be debited to this account. However, only two entries will be passed:

(*i*) For crediting as profit on revaluation to old partners' accounts:

Memorandum *P* & *L* Adjustment A/c Dr.

To Old Partners'Capital Accounts (in old ratio)

In case of loss the entry will be reversed.

(*ii*) For writing off the profit on revaluation to all partners' capital accounts (including the new partner):

Partners' Capital Accounts (in the new ratio) Dr.

To Memorandum *P* & *L* Adjustment A/c

In case of loss the entry will be reversed.

Illustration 10.13. Following is the Balance Sheet of Messers *A* and *B* who are sharing profits in the ratio of 3 : 2.

NOTES

BALANCE SHEET

as on 31 December, 2016

Liabilities	₹	*Assets*	₹
Sundry Creditors	10,000	Cash	5,000
Capitals:		Sundry Debtors	10,000
A	20,000	Buildings	20,000
B	10,000	Plant	5,000
	40,000		40,000

C is admitted as a partner with effect from 1 January, 2017, the new profit sharing ratio being 2 : 2 : 1. The following information has been given to you:

(*i*) *C* will bring ₹10,000 as capital.

(*ii*) The value of the firm's goodwill is ₹5,000.

(*iii*) An amount of ₹2,000 owing to *D* for purchase of goods has been omitted from the list of sundry creditors.

(*iv*) Building is to be revaluated at ₹30,000 and Plant at ₹7,000.

You are required to pass the necessary Journal entries and prepare the Balance Sheet of the new firm when:

(a) assets and liabilities have to be shown in the books at the revised values.

(b) assets and liabilities have to continue in the books at the old values.

Solution: (*a*) **When new values have to be recorded in the books**

JOURNAL

	Particulars		*Dr.* (₹)	*Cr.* (₹)
	Cash A/c	Dr.	10,000	
	To *C*'s Capital A/c			10,000
	(Being capital brought in by *C*)			
	Goodwill A/c	Dr.	5,000	
	To *A*'s Capital A/c			3,000
	To *B*'s Capital A/c			2,000
	(Goodwill A/c raised on *C*'s admission)			

	Particulars		*Dr.* (₹)	*Cr.* (₹)
	P & *L* Adjustment A/c	Dr.	2,000	
	To Sundry Creditors			2,000
	(A liability omitted now recorded)			
	Plant A/c	Dr.	2,000	
	Building A/c	Dr.	10,000	
	To *P* & *L* Adjustment A/c			12,000
	(Increase in the value of assets recorded)			
	P & *L* Adjustment A/c	Dr.	10,000	
	To *A*'s Capital A/c			6,000
	To *B*'s Capital A/c			4,000
	(Profit on revaluation credited to partners)			

NOTES

BALANCE SHEET

as on January 1, 2017

Liabilities	₹	*Assets*	₹
Sundry Creditors	12,000	Cash	15,000
Capital:		Sundry Debtors	10,000
A	29,000	Plant	7,000
B	16,000	Buildings	30,000
C	10,000	Goodwill	5,000
	67,000		67,000

Working Notes:

P & *L* ADJUSTMENT ACCOUNT

Liabilities	₹	*Assets*	₹
To Sundry Creditors	2,000	By Plant A/c	2,000
To Profit:		By Building A/c	10,000
A's Capital A/c	6,000		
B's Capital A/c	4,000		
	12,000		12,000

PARTNERS' CAPITAL ACCOUNTS

Particulars	*A* ₹	*B* ₹	*C* ₹	*Particulars*	*A* ₹	*B* ₹	*C* ₹
To Balance c/d	29,000	16,000	10,000	By Balance b/d	20,000	10,000	—
				By Goodwill	3,000	2,000	—
				By *P* & *L* Adjustment A/c	6,000	4,000	—
				By Cash			10,000
	29,000	16,000	10,000		29,000	16,000	10,000

(*b*) When new values have not to be recorded in the books

	Particulars		*Dr.* (₹)	*Cr.* (₹)
	Cash A/c	Dr.	10,000	
	To *C*'s Capital A/c			10,000
	(Being capital brought in by *C*)			
	Goodwill A/c	Dr.	5,000	
	To *A*'s Capital A/c			3,000
	To *B*'s Capital A/c			2,000
	(Goodwill A/c raised on *C*'s admission)			

	Particulars		*Dr.* (₹)	*Cr.* (₹)
	A's Capital A/c	Dr.	2,000	
	B's Capital A/c	Dr.	2,000	
	C's Capital A/c	Dr.	1,000	
	To Goodwill A/c			5,000
	(Goodwill account written off)			
	Memorandum *P* & *L* Adj. A/c	Dr.	10,000	
	To *A*'s Capital A/c			6,000
	To *B*'s Capital A/c			4,000
	(Being profit on revaluation credited to partners capital accounts)			
	A's Capital A/c	Dr.	4,000	
	B's Capital A/c	Dr.	4,000	
	C's Capital A/c	Dr.	2,000	
	To Memorandum *P* & *L* Adj. A/c			10,000
	(Being profit on revaluation written off)			

NOTES

PARTNERS' CAPITAL ACCOUNTS

Particulars	A (₹)	B (₹)	C (₹)	Particulars	A (₹)	B (₹)	C (₹)
To Goodwill A/c	2,000	2,000	1,000	By Balance b/d	20,000	10,000	—
To Memorandum *P* & *L* Adjustment A/c	4,000	4,000	2,000	By Goodwill A/c	3,000	3,000	—
To Balance c/d	23,000	10,000	7,000	By Memorandum *P* & *L* Adjustment A/c	6,000	6,000	
				By Cash			10,000
	29,000	16,000	10,000		29,000	16,000	10,000

BALANCE SHEET

as on January 1, 2017

Liabilities	₹	Assets	₹
Sundry Creditors	10,000	Cash	15,000
Capital:		Sundry Debtors	10,000
A	23,000	Plant	5,000
B	10,000	Buildings	20,000
C	7,000		
	50,000		50,000

Working Notes:

MEMORANDUM *P* & *L* ADJUSTMENT ACCOUNT

Liabilities	₹	Assets	₹
To Sundry Creditors	2,000	By Plant A/c	2,000
To Profit		By Building A/c	10,000
A's Capital A/c	6,000		
B's Capital A/c	4,000		
	12,000		12,000
To Reversal of entry (increase in the value of assets)	12,000	By Reversal of entry (increase in the value of liabilities)	2,000
		By *A*'s Capital A/c	4,000
		By *B*'s Capital A/c	4,000
		By *C*'s Capital A/c	2,000
	12,000		12,000

Adjustments for Reserves and other Accumulated Profits

The amount standing to the credit of Reserves, representing accumulated profits or balance in the Profit & Loss Account should be distributed among the old partners in the old profit sharing ratio. The accounting entry will be:

P & *L* Account (if profit) Dr.

General Reserve Dr.

To Old Partners' Capital Accounts (in the old ratio)

In case it is desired to leave the Reserves and *P* & *L* Account undisturbed, one more entry reversing the amount credited may be passed:

All Partners' Capital Accounts Dr.

(in the new ratio)

To *P* & *L* A/c

To General Reserve

NOTES

In place of passing two entries only one entry may be passed crediting or debiting the partners with the net amount.

Illustration 10.14. *A* and *B* are partners in a business sharing profits and losses in the ratio of 3 : 2. They admit a new partner *C* with 1/5 share in the profits. The following amounts represented undistributed profits among the partners on the date of admission of *C*:

		₹
(*i*)	*P & L* A/c balance	5,000
(*ii*)	General Reserve	10,000

You are required to pass the necessary Journal entries when:

(*i*) Old *P & L* A/c and General Reserve balances are not to appear in the New Firm's books:

(*ii*) Old *P & L* A/c and General Reserve balances are to appear in the New Firm's books.

Solution:

(*i*) JOURNAL ENTRIES

	Particulars		Dr. (₹)	Cr. (₹)
	P & L A/c	Dr.	5,000	
	General Reserve	Dr.	10,000	
	To *A*'s Capital A/c			9,000
	To *B*'s Capital A/c			6,000
	(Being the amount of *P & L* A/c and General Reserve distributed among the partners)			

(*ii*) JOURNAL ENTRIES

	Particulars		Dr. (₹)	Cr. (₹)
	P & L A/c	Dr.	5,000	
	General Reserve	Dr.	10,000	
	To *A*'s Capital A/c			9,000
	To *B*'s Capital A/c			6,000
	(Being the amount credited to old partners on account of *P & L* A/c balance and General Reserve)			
	A's Capital A/c	Dr.	7,200	
	B's Capital A/c	Dr.	4,800	
	C's Capital A/c	Dr.	3,000	
	To *P & L* A/c			5,000
	To General Reserve			10,000
	(The amount credited to partners written off)			

OR

In place of passing the two entries one entry may be passed. The new partner may be debited with the share in the *P & L* A/c and General Reserve balances and the old partners be credited in the ratio in which they lose.

	Particulars		Dr. (₹)	Cr. (₹)
	C's Capital A/c	Dr.	3,000	
	To *A*'s Capital A/c			1,800
	To *B*'s Capital A/c			1,200
	(Being adjustment for accumulated profit on admission of *C*)			

NOTES

Check Your Progress

3. What are the conditions within which there is a reconstitution of a partnership firm?
4. List two ways in which the problem of goodwill on admission of a new partner can be dealt with.
5. What does AS 26 prescribe about intangible assets?

10.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. As per the Companies Act, 2013, the number of partners in a partnership firm should not exceed such numbers as may be presented. At present, it has been prescribed as 50 which shall not exceed 100.
2. In the absence of any provision to the interest on advances in the partnership deed/agreement, a partner who makes an advance of money to the firm beyond the amount of his capital for the purposes of business, is entitled to get interest thereon at the rate of 6% per annum.
3. Any change in the relations of the partners will result in the reconstitution of a partnership firm. The firm is, therefore, said to be reconstituted when there is admission, retirement or death or where a partnership firm gets amalgamated with another partnership firm.
4. The problem of goodwill on admission of a new partner can be dealt in two different ways:
   - When the goodwill account already appears in the books.
   - When the goodwill account is not appearing in the books at the time of admission of a partner.
5. In relation to intangible assets, the AS 26 prescribes that internally generated goodwill should not be recognized as an asset. This is because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

10.5 SUMMARY

- Partnership form of business organization came into existence on account of limitations of sole proprietary concerns. The major limitations of sole proprietary concerns are those of shortage of funds, uncertainty about existence, unlimited personal liability etc. In case of a partnership business two or more persons join hands together to do a business. Thus, the risk, funds, responsibility all are shared.

NOTES

- The Indian Partnership Act, 1932 is applicable to contracts of Partnership. According to Section 4 of the said Act partnership is "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all". Persons who have entered into partnership with one another are called individually 'partners' and collectively a 'firm' and the name under which the business is carried on is called the 'firm's name'.
- A partnership business must satisfy all the following essential elements. They must exist together. Absence of any one of them may cut the roots of partnership. These features are: there must be an association of two or more persons, there must be an agreement entered into by all persons concerned, business must be carried on by all or any of the persons concerned acting for all.
- Partnership is created by an agreement. It is not necessary that the agreement should be in writing. It may be oral but to avoid future disputes it is always better to have it in writing. The document in writing containing the important terms of partnership as agreed by the partners between themselves is called the Deed of Partnership. It should be properly drafted and stamped according to the provisions of The Stamp Act.
- It is better if the deed is very elaborate and clear about all questions which may arise in the course of partnership. In the absence of any agreement the rights and duties of partners will be those which have been given in the Partnership Act. These are right to share profits, interest on capital, interest on advances, right to share subsequent profits after retirement and no remuneration for firm's work.
- Any change in the relations of the partners will result in the reconstitution of a partnership firm. The firm is, therefore, said to be reconstituted when there is admission, retirement or death of a partner or where a partnership firm gets amalgamated with another partnership firm.
- Section 31 of the Partnership Act deals with the statutory provisions regarding admission of a new partner. These provisions are summarised below:
  (i) A new partner cannot be admitted without the consent of all the partners unless otherwise agreed upon.
  (ii) A new partner admitted to an existing firm, is not liable to any debts of the firm incurred, before he comes in as a partner. The new partner cannot be held responsible for the acts of the old partners unless it is proved that:
    (a) the reconstituted firm has assumed the liability to pay the debt; and

(b) that the creditor concerned has agreed to accept the reconstituted firm as his debtor and to discharge the old firm from liability.

- The accounting problems on admission of a new partner can be put as follows:
  - (i) Adjustment in the profit sharing ratio.
  - (ii) Adjustment for goodwill.
  - (iii) Adjustment for revaluation of assets and liabilities.
  - (iv) Adjustment for reserves and other accumulated profits.
  - (v) Adjustment for capital.

10.6 KEY WORDS

- **Memorandum Revaluation Account:** This is also known as Memorandum Profit & Loss Adjustment Account. It is similar to revaluation account except that it is only a memorandum record of increase or decrease in the values of assets and liabilities on reconstitution of a partnership firm. The assets and liabilities continue to appear at their old values in the balance sheet and entry is passed only with the net profit or loss made or suffered by the partners on reconstitution of the firm.
- **Revaluation Account:** This is also known as Profit & Loss Adjustment account. The account records any increase or decrease in the values of assets and liabilities as agreed by the partners on reconstitution of a partnership firm. The balance of the account represents profit or loss made on revaluation to be shared by the partners.
- **Sacrificing Ratio:** The term is used generally in case of admission of a partner. It is the ratio in which the existing partners lose on admission of a new partner.

10.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Why assets and liabilities are revalued on admission of a partner? Give imaginary entries covering such revaluation.
2. What is 'Goodwill'?
3. If there is a change in the profit sharing ratio of the existing partners, is it necessary to revalue the assets and liabilities? Give reasons for your answer.

4. Distinguish between Revaluation Account and Memorandum Revaluation Account.

Long Answer Questions

NOTES

1. What could be the several alternatives regarding adjustment for goodwill in the event of admission of a partner?
2. State the ratio and the Journal entry for the following adjustments in the event of admission of a partner
   (a) When goodwill account is raised.
   (b) When goodwill account is written off.
   (c) When the new partner brings cash for his share of goodwill.
   (d) When there is profit or loss on revaluation of assets.

   [Ans. (a) old, (b) new, (c) sacrificing, (d) old]
3. Explain the following methods of calculating goodwill of a partnership firm:
   (i) Purchase of a certain number of years' average profit method.
   (ii) Super-Profits method.
4. Explain the accounting treatment of 'Goodwill' when at the time of admission, the new partner cannot bring his share of goodwill in cash.

10.8 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 11 RETIREMENT AND DEATH OF A PARTNER

Structure

11.0 Introduction
11.1 Objectives
11.2 Retirement of a Partner
11.3 Death of a Partner
11.4 Answers to Check Your Progress Questions
11.5 Summary
11.6 Key Words
11.7 Self Assessment Questions and Exercises
11.8 Further Readings

11.0 INTRODUCTION

In the previous unit, we studied the reconstitution of partnership accounts under the condition of admission of new partner in the partnership. In this unit, we will take up the other conditions under which the partnership accounts go under reconstitution. These conditions are retirement and death of a partner. On retirement of a partner from the firm may result in the dissolution or reconstitution of the firm. Generally, a partner retires from the firm because he/she is too old, they have a better opportunity in their kitty or they are unhappy with the attitude or behaviour of their partners. Death of the partner, as the name suggests means the actual death of the partner. In both these cases, different items like the assets and liabilities, goodwill, accumulated reserves are to be adjusted and new calculations done with regards to the profit sharing and loss sharing ratio and the amount due to the former partner.

11.1 OBJECTIVES

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

- Discuss the meaning of retirement of a partner
- Describe the calculation of new profit sharing ratio and gaining ratio when a partner retires
- Explain the adjustments with regards to Goodwill in case of a retiring partner
- Examine the revaluation of assets and liabilities in case of retiring partners

NOTES

- Recall the provisions in case of settling claims of retiring partner
- Describe the concept of death of a partner in a partnership

11.2 RETIREMENT OF A PARTNER

Section 32 of the Partnership Act deals with the statutory provisions relating to retirement of a partner from partnership firm. These provisions are summarised below:

(*i*) A partner may retire from the firm:

(*a*) in accordance with an express agreement; or

(*b*) with consent of all other partners; or

(*c*) where the partnership is at will[1], by giving a notice in writing to all the other partners of his intention to retire.

(*ii*) A retiring partner may carry on business competing with that of the firm and may advertise such business. But he has no right to:

(*a*) use the name of the firm,

(*b*) represent himself as carrying on the business of the firm, or

(*c*) solicit the custom of the old customers of the firm except when he obtains these rights by an agreement with the other partners of the firm.

(*iii*) A retiring partner will not be liable for liabilities incurred by the firm after his retirement. However, he must give a public notice to that effect. Such a public notice is not necessary in case of a sleeping or dormant partner.[2]

(*iv*) Retirement of a partner by death or insolvency also does not require any public notice.

Accounting Problems

The accounting problems in the event of retirement of a partner can be put as follows:

(*i*) Adjustment for Goodwill.

(*ii*) Revaluation of assets and liabilities.

(*iii*) Adjustment regarding Reserves and other undistributed profits.

(*iv*) Adjustments regarding profit sharing ratios.

(*v*) Payment to the retiring partner.

1. **Goodwill** The retiring partner will be entitled to his share of goodwill in the firm. The problem of goodwill can be dealt in the following two different ways:

(*a*) *Where goodwill account is already appearing in the books:*

(*i*) In such a case if goodwill is properly valued, no further adjustment will be needed. The amount has already been credited to all the partners including the retiring partner.

(*ii*) In case goodwill is not properly valued, an adjustment entry will be required only for the difference. For example *A, B* and *C* are three partners sharing profits and losses in the ratio of 2 : 2 : 1. The goodwill is appearing in the books at ₹10,000. *C* retires and on the date of his retirement, the goodwill is valued at ₹15,000. The following Journal entry will be passed for ₹5,000.

Goodwill A/c Dr.	5,000	
To *A*'s Capital A/c		2,000
To *B*'s Capital A/c		2,000
To *C*'s Capital A/c		1,000
(Being adjustment for goodwill on retirement of *C*)		

(*b*) *Where goodwill account is not appearing in the books:*

There could be several alternatives:

(*i*) Goodwill account may be raised in the books.

Goodwill A/c Dr.
To Old Partners' Capital A/c
(The amount of goodwill credited to old partners
including the retiring partner in their old profit sharing ratio)

(*ii*) In case continuing partners decide not to continue with the goodwill account, it may be written off.

Continuing Partners Capital A/cs Dr.
To Goodwill A/c
[Goodwill written off to the continuing partners A/c
(*i.e.*, new partners) in the new ratio]

(*iii*) Entry may be made only with the share of goodwill of the retiring partner.

Goodwill A/c Dr.
(only with the share of the retiring partner)
To Retiring Partner's Capital A/c

(*iv*) The share of goodwill of the retiring partner may be adjusted in the accounts of the continuing partners without raising a goodwill account.

Continuing Partners' Capital A/c Dr.
(in the ratio in which they gain on retirement)
To Retiring Partner's Capital A/c

NOTES

Illustration 11.1. *A, B* and *C* are partners in business sharing profits and losses in the ratio of 2 : 2 : 1. *C* retires from the firm and on this date the value of firm's goodwill (for which no account appears in the books) was determined at ₹10,000.

You are required to pass suitable Journal entries for each of the following cases:

(*i*) When goodwill account is to be raised in the books.

(*ii*) When the goodwill account raised is subsequently written off.

(*iii*) When only *C*'s share is to be recorded.

(*iv*) When *C*'s share is to be adjusted into accounts of *A* and *B* without raising a Goodwill account in the firm's book.

Solution:

JOURNAL

	Particulars		*Dr.* (₹)	*Cr.* (₹)
(*i*)	Goodwill A/c	Dr.	10,000	
	To *A*'s Capital A/c			4,000
	To *B*'s Capital A/c			4,000
	To *C*'s Capital A/c			2,000
	(Goodwill account raised in the books)			
(*ii*) (*a*)	Goodwill A/c	Dr.	10,000	
	To *A*'s Capital A/c			4,000
	To *B*'s Capital A/c			4,000
	To *C*'s Capital A/c			2,000
	(Being goodwill account raised)			
(*b*)	*A*'s Capital A/c	Dr.	5,000	
	B's Capital A/c	Dr.	5,000	
	To Goodwill A/c			10,000
	(Being goodwill raised now written off in the new profit sharing ratio)			
(*iii*)	Goodwill A/c	Dr.	2,000	
	To *C*'s Capital A/c			2,000
	(Being share of goodwill recorded)			
(*iv*)	*A*'s Capital A/c	Dr.	1,000	
	B's Capital A/c	Dr.	1,000	
	To *C*'s Capital A/c			2,000
	(*A* and *B* debited with *C*'s share of goodwill in the ratio of their gain on *C*'s retirement)			

2. **Revaluation of assets and liabilities** A Profit and Loss Adjustment account will be opened in the firm's books and profit or loss on revaluation will be credited or debited to all the partners (including the retiring partner) in the old ratio. The assets and liabilities will appear at the revised values in the new balance sheet after retirement.

In case it is desired that assets and liabilities should continue to appear at the old values, the entries for profit or loss on revaluation will be done through Memorandum Profit and Loss Adjustment Account as explained in the previous unit in "Admission of a Partner".

Illustration 11.2. *A, B* and *C* are sharing profits in a business in the ratio of 3 : 2 : 1.

NOTES

Their Balance Sheet as on December 31, 2009 was as under:

Liabilities		₹	*Assets*		₹
Sundry Creditors		10,000	Cash	5,000	
Loan from	*D*	20,000	Debtors	10,000	
Capitals	*A*	20,000	Stock	20,000	
	B	20,000	Plant	50,000	
	C	15,000			
		85,000		85,000	

C retires on this date. The following arrangement is agreed upon:

(*i*) The value of the Firm's goodwill is ₹15,000. *C*'s share of the same is to be adjusted in the accounts of *A* and *B*.

(*ii*) The assets are revalued as follows:

Stock 25,000

Plant 52,000

(*iii*) A provision for bad debts is to be created on debtors @ 10% of debtors.

(*iv*) The amount due to *C* is to be transferred to a loan account in his name.

You are required to prepare the Profit and Loss Adjustment Account, Capital Accounts of the Partners and the Balance Sheet of the business:

(*a*) When assets are to be shown at new values in the books.

(*b*) When assets are to be shown at old values.

Solution:

(*a*) *When assets are to be shown at new values.*

Dr. *P & L* ADJUSTMENT ACCOUNT *Cr.*

Particulars	₹	*Particulars*	₹
To Provision bad debts	1,000	By Stock	5,000
To Profit:		By Plant	2,000
A's Capital A/c	3,000		
B's Capital A/c	2,000		
C's Capital A/c	1,000		
	7,000		7,000

Dr. CAPITAL ACCOUNTS *Cr.*

Particulars	*A* ₹	*B* ₹	*C* ₹	*Particulars*	*A* ₹	*B* ₹	*C* ₹
To *C*'s Capital A/c (Goodwill)	1,500	1,000		By Balance b/d	20,000	20,000	15,000
				By *P & L* Adj. A/c	3,000	2,000	1,000
To Balance c/d	21,500	21,000		By *A*'s Cap. A/c (Goodwill)			1,500
To *C*'s Loan A/c			18,500	By *B*'s Cap. A/c (Goodwill)			1,000
	23,000	22,000	18,500		23,000	22,000	18,500

NOTES

BALANCE SHEET

Dr. *as on 1st January, 2017* *Cr.*

Liabilities	₹	*Assets*		₹
Sundry Creditors	10,000	Cash		5,000
Loan from *D*	20,000	Debtors	10,000	
Loan from *C*	18,500	*Less:* Provision	1,000	9,000
Capitals:				
A	21,500	Stock		25,000
B	21,000	Plant		52,000
	91,000			91,000

(*b*) *When assets are to be shown at old values.*

Dr. MEMORANDUM *P* & *L* ADJUSTMENT ACCOUNT *Cr.*

Particulars	₹	*Particulars*	₹
To Provision for bad debts	1,000	By Stock	5,000
To Profit:		By Plant	2,000
A's Capital A/c	3,000		
B's Capital A/c	2,000		
C's Capital A/c	1,000		
	7,000		7,000
To Reversal of entry (increase in the value of assets)	7,000	By Reversal of entry (decrease in the value of assets)	1,000
		By *A*'s Capital A/c	3,600
		By *B*'s Capital A/c	2,400
	7,000		7,000

Dr. PARTNERS' CAPITAL ACCOUNTS *Cr.*

Particulars	*A* ₹	*B* ₹	*C* ₹	*Particulars*	*A* ₹	*B* ₹	*C* ₹
To *C*'s Capital A/c	1,500	1,000		By Balance b/d	20,000	20,000	15,000
To Memorandum *P* & *L* Adj. A/c	3,600	2,400	—	By Memorandum *P* & *L* Adj. A/c	3,000	2,000	1,000
To *C*'s Loan A/c	—	—	18,500	By *A*'s Capital A/c (Goodwill)	—	—	1,500
To Balance c/d	17,900	18,600	—	By *B*'s Capital A/c (Goodwill)	—	—	1,000
	23,000	22,000	18,500		23,000	22,000	18,500

BALANCE SHEET

Dr. as on 1st January, 2017 Cr.

Liabilities	₹	*Assets*	₹
Sundry Creditors	10,000	Cash	5,000
Loan from *D*	20,000	Debtors	10,000
Loan from *C*	18,500	Stock	20,000
Capitals:		Plant	50,000
A	17,900		
B	18,600		
	85,000		85,000

3. **Reserves and other Undistributed Profits** The amount standing as reserves or undistributed profits in the books of the firm will be distributed among all the partners in their old profit sharing ratio.

NOTES

The journal entry will be:

Reserves or P & L A/c Dr.

To Partners' Capital A/c

In case it is desired that only retiring partner should be credited with his share in reserves or undistributed profit, the following journal entry will be passed:

Reserves or P & L A/c Dr.

To Retiring Partners' Capital A/c

(only with his share)

The balance of Reserves or undistributed profits will continue to appear in the Balance Sheet after such retirement.

In case it is desired that the retiring partner should be given the benefit of Reserves or undistributed profits without in any way disturbing the Reserves or undistributed profits, the following journal entry will be passed:

Continuing Partners' Capital A/c Dr.

(in the ratio they gain)

To Retiring Partner's Capital A/c

(only with his share)

Illustration 11.3. *A, B* and *C* are partners in a business sharing profits and losses in the ratio of 2 : 2 : 1. *C* retires from the business. The General Reserve stands at ₹5,000 on the date of *C*'s retirement. *A* and *B* agree to share the future profits in the ratio of 3 : 2 respectively.

You are required to pass the necessary journal entry for distribution of General Reserve if

(*a*) The General Reserve is not allowed to be kept in the books.

(*b*) The General Reserve is kept only at an amount remaining after giving *C* his share.

(*c*) The General Reserve is allowed to be kept at the full value.

Solution:

	Particulars		Dr. (₹)	Cr. (₹)
(*a*)	General Reserve A/c	Dr.	5,000	
	To *A*'s Capital A/c			2,000
	To *B*'s Capital A/c			2,000
	To *C*'s Capital A/c			1,000
	(General Reserve distributed among the partners)			
(*b*)	General Reserve	Dr.	1,000	
	To *C*'s Capital A/c			1,000
	(*C*'s share in General Reserve credited to his account)			
(*c*)	*A*'s Capital A/c	Dr.	1,000	
	To *C*'s Capital A/c			1,000
	(*A* is debited with *C*'s share of General Reserve since he alone stands to gain on account of *C*'s retirement)			

4. **Profit Sharing Ratio** In the absence of any other agreement between the partners, the continuing partners will continue to share the profits or losses in between themselves in the same ratio in which they were sharing before retirement of a partner.

For example if *A, B* and *C* were sharing profits in the ratio of 3 : 2 : 1 respectively and *C* retires, the profit sharing ratio between *A* and *B* would continue to be 3 : 2.

In other words it can be said that the share of the retiring partner will be shared by the continuing partners in their old profit sharing ratio. The ratio in which they share the retiring partner's share is termed as their "*gaining ratio*".

In the above example, the share of retiring partner is 1/6. This shall go to *A* and *B* in the ratio of 3/5 to *A* and 2/5 to *B* which means:

A's share $= \frac{3}{6} + \frac{1}{6} \times \frac{3}{5} = \frac{3}{6} + \frac{3}{30} = \frac{15+3}{30} = \frac{18}{30}$

B's share $\frac{2}{6} + \frac{1}{6} \times \frac{2}{5} = \frac{2}{6} + \frac{2}{30} = \frac{10+3}{30} = \frac{12}{30}$

or the ratio comes to 3 : 2.

The continuing partners may agree to share, the share of the retiring partner in an agreed ratio. For example, if in the above example, *C*'s share of 1/6 is shared by *A* and *B* equally, the new profit sharing ratio will be:

A $\frac{3}{6} + \frac{1}{12} = \frac{6+1}{12} = \frac{7}{12}$

B $\frac{2}{6} + \frac{1}{12} = \frac{4+1}{12} = \frac{5}{12}$

Thus, the new profit sharing ratio of *A* and *B* will be 7 : 5 respectively.

Illustration 11.4. *A, B* and *C* were partners sharing profits and losses in the ratio of 3/6, 2/6 and 1/6.

Calculate the new and gaining ratios in each of the following cases:

(*a*) *A* retires; (*b*) *B* retires; (*c*) *C* retires.

Solution:

New Ratios

(*i*) *When A retires. B* and *C* will continue to share the profits in the old ratio *i.e.*, 2/6 and 1/6 or 2 : 1.

(*ii*) *When B retires. A* and *C* will continue to share the profits in the old ratio *i.e.*, 3/6 and 1/6 or 3 : 1.

(*iii*) *When C retires. A* and *B* will continue to share the profits in the old ratio *i.e.*, 3/6 and 2/6 or 3 : 2.

NOTES

Gaining Ratio

In each of the above cases, since nothing contrary has been given, the gaining ratio will be the same as old profit sharing ratio *i.e.*, (*i*) 2 : 1 (*ii*) 3 : 1 and (*iii*) 3 : 2. This can be verified as follows:

Gaining Ratio = New Ratio – Old Ratio

When A retires

For B $$= \frac{2}{3} + \frac{2}{6} = \frac{4-2}{6} = \frac{2}{6}$$

For C $$= \frac{1}{3} + \frac{1}{6} = \frac{2-1}{6} = \frac{1}{6}$$

Gaining Ratio $$= \frac{2}{6} : \frac{1}{6} \quad \text{or} \quad 2:1$$

When B retires

For A $$= \frac{3}{4} + \frac{3}{6} = \frac{18-12}{24} = \frac{6}{24}$$

For C $$= \frac{1}{4} + \frac{1}{6} = \frac{6-4}{24} = \frac{2}{24}$$

Gaining Ratio $$= \frac{6}{24} : \frac{2}{24} \quad \text{or} \quad 3:1$$

When C retires

For A $$= \frac{3}{5} - \frac{3}{6} = \frac{18-15}{30} = \frac{3}{30}$$

For B $$= \frac{2}{5} + \frac{2}{6} = \frac{12-10}{30} = \frac{2}{30}$$

Gaining Ratio $$= \frac{3}{30} : \frac{2}{30} \quad \text{or} \quad 3:2$$

Illustration 11.5. *A, B* and *C* are partners in a business, sharing profits in the ratio of 2 : 2 : 1. *A* retires and he sells his share in the business for a sum of ₹6,000; ₹4,800 is paid by *B* and ₹1,200 by *C*. The profit for the year after *A*'s retirement amounts to ₹10,000.

You are required to give the necessary Journal entries.

NOTES

Solution:

JOURNAL

	Particulars	Dr. (₹)	Cr. (₹)
	Bank A/c Dr.	6,000	
	To *B*'s Capital A/c		4,800
	To *C*'s Capital A/c		1,200
	(Being cash brought by *B* and *C* to pay off on his retirement)		
	A's Capital A/c Dr.	6,000	
	To Bank		6,000
	(Being amount paid to *A* on his retirement)		
	Profit and Loss Appropriation A/c Dr.	10,000	
	To *B*'s Capital A/c		7,200
	To *C*'s Capital A/c		2,800
	(Being the amount of profit distributed among partners)		

Working Notes:

The new profit sharing ratio has been calculated as under:

B pays ₹4,800

C pays ₹1,200

This means *B* has bought 4/5 of *A*'s share and *C* has bought 1/5.

B's share would therefore be:

$$\frac{2}{5}+\frac{2}{5}\times\frac{4}{5}=\frac{2}{5}+\frac{8}{25}=\frac{10+8}{25}=\frac{18}{25}$$

C's share would therefore be:

$$\frac{1}{5}+\frac{2}{5}\times\frac{1}{5}=\frac{1}{5}+\frac{2}{25}=\frac{5+2}{25}=\frac{7}{25}$$

Thus, the new ratio would be:

$$\frac{18}{25}:\frac{7}{25} \quad \text{or} \quad 18:17$$

5. **Payment** The amount due to the retiring partner will be paid as per terms of the partnership agreement or as otherwise mutually agreed. When the amount payable to the retiring partner is determined, it will be transferred to his loan account. The Journal entry will be:

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

In case the continuing partners agree to bring cash to pay off the retiring partner, the entries will be

Bank Dr.

To Continuing Partners' Capital A/c

(For cash brought in by the partners in the agreed ratio
to pay off the retiring partner)

Retiring Partner's Capital A/c Dr.
To Bank
(For cash paid to the retiring partner)

In case the continuing partners decide to pay the retiring partner in their individual capacity in their profit sharing ratio, the entry will be:

Retiring Partner's Capital Loan A/c Dr.
To Continuing Partner's Capital A/c

Payment in Instalments

The amount due to the retiring partner may be agreed to be paid in equal instalments together with interest at the agreed rate.

In such a case there may be two situations:

(*i*) Equal instalments may only be regarding 'principal' amount. Interest on outstanding balance is paid in addition to the instalment amount (*See Illustration 11.6*).

(*ii*) Equal instalment may be both as regards interest as well as principal. In such a case the amount of instalment is calculated with the help of Annuity Table (*See Illustration 11.8*).

Illustration 11.6. The total amount due to the retiring partner *A* is ₹12,000. It is to be paid in ten equal annual instalments with interest at 10% p.a. The first instalment to be paid after the expiry of one year after from the date of retirement. Prepare *A*'s loan account for the first three years.

Solution:

A's LOAN ACCOUNT

Particulars	₹	*Particulars*	₹
1st Year			
To Bank	2,400	By *A*'s Capital A/c	12,000
(Principal 1,200 + Interest 1,200)		By Interest	1,200
To Balance c/d	10,800		
	13,200		13,200
2nd Year			
To Bank (1,200 + 1,080)	2,280	By Balance b/d	10,800
To Balance c/d	9,600	By Interest	1,080
	11,880		11,880
3rd Year			
To Bank (1,200 + 960)	2,160	By Balance b/d	9,600
To Balance c/d	8,400	By Interest	960
	10,560		10,560

Illustration 11.7. Nut, Bolt and Screw are partners sharing profits and losses in the ratio of 4 : 2 : 1.On 1st January, 2016, Screw retires. On that date, the capital accounts of the partners showed credit balances of Nut ₹12,000, Bolt ₹10,000 and Screw ₹9,000. It was provided in the Partnership Deed that in case of retirement, the retiring partner should be entitled to a share of the

goodwill of the firm to be calculated at two years' purchase of the average profits of the last three years, and that the payment of the capital and share of goodwill to the retiring partner shall be made by annual instalment of ₹4,000 each, for the first two years and the balance in the last year, interest being calculated at 10% on the unpaid balances.

The Profit for the years 2013, 2014 and 2015 were ₹8,600, ₹7,600 and ₹4,800 respectively.

The first instalment was paid on 31st December, 2016.

Show Screw's Loan Account until the payment of the whole amount due to him was made.

Solution:

Dr. SCREW'S CAPITAL ACCOUNT *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2016			2016		
Jan. 1	To transfer to Screw's Loan A/c	11,000	Jan. 1	By Balance b/d	9,000
				By Goodwill A/c	2,000
		11,000			11,000

Dr. SCREW'S LOAN ACCOUNT *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2016			2016		
Dec. 31	To Bank	4,000	Jan. 1	By Transfer from Screw's Capital A/c	11,000
	To Balance c/d	8,100	Dec. 31	By Interest @ 10% (11,000 × 10/100)	1,100
		12,100			12,100
			2017		
Dec. 31	To Bank	4,000	Jan. 1	By Balance b/d	8,100
	To Balance c/d	4,910	Dec. 31	By Interest @ 10% (8,100 × 10/100)	810
		8,910			8,910
			2018		
Dec. 31	To Bank	5,401	Jan. 1	By Balance b/d	4,910
			Dec. 31	By Interest (4,910 × 10/100)	491
		5,401			5,401

Working Note:

Computation of Goodwill

Profits for the three years were:

	₹
2013	8,600
2014	7,600
2015	4,800
Total Profits for three years	21,000

Average Profit = 21,000/3 = ₹7,000

Value of Goodwill = ₹7,000 × 2 = ₹14,000

Screw's Share of Goodwill = 14,000 × 1/7 = ₹2,000.

NOTES

Illustration 11.8. *A, B* and *C* were carrying on business in partnership sharing profit and losses in the ratio of 3 : 2 : 1 respectively. On 31st December, 2015 Balance Sheet of the firm stood as follows:

Liabilities		₹	*Assets*	₹
Sundry Creditors		13,590	Cash	5,900
Capital Accounts:			Debtors	8,000
A	15,000		Stock	11,690
B	10,000		Buildings	23,000
C	10,000	35,000		
		48,590		48,590

B retired on the above mentioned date on the following terms:

(*i*) Buildings be appreciated by ₹7,000.

(*ii*) Provision for bad debts be made @ 5% on Debtors.

(*iii*) Goodwill of the firm be valued at ₹9,000 and adjustment in this respect be made without raising a Goodwill Account.

(*iv*) ₹5,000 be paid to *B* immediately and the balance due to him be treated as a loan carrying interest @ 6% per annum. Such loan is to be paid to three equal annual instalments including interest.

Pass Journal entries to record above mentioned transactions and show the Balance Sheet of the firm as it would appear immediately after *B*'s retirement. Prepare also *B*'s Loan Account till it is finally closed.

Solution:

JOURNAL

	Particulars		*Dr.* (₹)	*Cr.* (₹)
	Buildings A/c	Dr.	7,000	
	To *P* & *L* Adjustment A/c			7,000
	(Being appreciation in the value of buildings)			
	P & *L* Adjustment A/c	Dr.	400	
	To Provision for Bad Debts			400
	(Being provision for bad debts created on debtors)			
	Profit and Loss Adjustment A/c	Dr.	6,600	
	To *A*'s Capital A/c			3,300
	To *B*'s Capital A/c			2,200
	To *C*'s Capital A/c			1,100
	(Being profit on revaluation credited to old partners)			
	A's Capital A/c	Dr.	2,250	
	C's Capital A/c	Dr.	750	
	To *B*'s Capital A/c			3,000
	(Being *B*'s share of goodwill adjusted)			
	B's Capital A/c	Dr.	5,000	
	To Bank A/c			5,000
	(Being the amount paid to *B* on retirement)			
	B's Capital A/c	Dr.	10,200	
	To *B*'s Loan A/c			10,200
	(Balance of amount due to *B* transferred to his loan account on his retirement)			

NOTES

BALANCE SHEET

as on January 1, 2016

Liabilities		₹	Assets		₹
Sundry Creditors		13,590	Cash		900
B's Loan A/c		10,200	Debtors	8,000	
Capital Accounts:			*Less*: Prov. for bad debts	400	7,600
A	16,050		Stock		11,690
C	10,350	26,400	Buildings	23,000	
			Add: Appreciation	7,000	30,000
		50,190			50,190

Dr. *B*'S LOAN ACCOUNT Cr.

Particulars	₹	Particulars	₹
2016			
To Bank	3,816	By Balance b/d	10,200
To Balance c/d	6,996	By Interest	612
	10,812		10,812
2017			
To Bank	3,816	By Balance b/d	6,996
To Balance c/d	3,600	By Interest	420
	7,416		7,416
2018			
To Bank	3,816	By Balance b/d	3,600
		By Interest	216
	3,816		3,816

Check Your Progress

1. Which section of the Partnership Act deals with the statutory provisions relating to retirement of a partner?
2. Mention the journal entry which should be passed in case it is desired that only retiring partner should be credited with his share in reserves or undistributed profit.
3. Mention the journal entry for continuing partners agree to bring cash to pay off the retiring partner.

11.3 DEATH OF A PARTNER

According to Section 35 of the Partnership Act, a partnership firm may not be dissolved on the death of a partner.

Where under a contract between the partners the firm is not dissolved by the death of a partner, the estate of the deceased partner is not liable for any act done or liability incurred after his death. No public notice is required for this purpose.

NOTES

In the event of death of a partner, the legal representatives of the deceased partner will be entitled to get from the firm, amounts due on account of following:

(*i*) Capital standing to the credit of the deceased partner on the date of his death.

(*ii*) Share of goodwill.

(*iii*) Profit on revaluation of assets and liabilities as reduced by any loss on any such revaluation.

(*iv*) Share out of the proceeds of a joint life insurance policy.

In case the firm has taken insurance policies severally on the life of each partner, the deceased's partner's executor's will be entitled to get not only a share out of the proceeds of the policy on his life but also a share out of the surrender values of the policies on the lives of other partners. However, the latter part will be applicable only when the entire premium paid on these policies has been charged to Profit & Loss Account and the policies are not appearing in the books of accounts.

For example, a Firm has taken life policies on the lives of all partners severally for *A* ₹10,000, *B* ₹5,000 and *C* ₹5,000. *A* dies. The premium paid has been charged to Profit & Loss Account each year. The surrender values of the policies of *B* and *C* are ₹2,000 each. The partners share profits and losses in the ratio of 2 : 2 : 1.

In this case, *A*'s executors will be entitled to:

(*a*)	Share out of the proceeds of life insurance policy on the life of *A*	₹
	i.e., 10,000 × 2/5	4,000
(*b*)	Share out of the surrender values of the life insurance policies on lives of *B* and *C* *i.e.,* 4,000 × 2/5	1,600
		5,600

(*v*) Share out of the reserves or other undistributed profits.

(*vi*) Share in the profits of the firm earned by the firm from the date of beginning of the year to the date of his death.

(*vii*) Interest on capital from the beginning of the year to the date of his death.

The deceased partner's capital account will be charged with his share of the following amounts:

(*i*) Drawings and interest thereon from the beginning of the accounting year to the date of his death.

(*ii*) Loss on revaluation of assets and liabilities.

(*iii*) Loss in the business from the beginning of the accounting year till the date of his death.

Ascertainment of the deceased partner's share in the profit of the firm The actual share of the deceased partner in the profit of the firm till the date of death can be calculated only by preparing the final accounts up to that date. However, it may not be very convenient. The profit may, therefore, be calculated according to any of the following methods:

1. **Time basis** The profit for the year can be divided between two periods:
   (*i*) beginning of the accounting year to the date of death of the partner.
   (*ii*) from the date of death of partner till the end of the accounting year.

The deceased partner's share can now be ascertained out of the profit ascertained for the period (*i*) stated above.

Illustration 11.9. *A, B* and *C* are partners in a business sharing profits in the ratio of 2 : 2 : 1. *C* dies on 1st April 2016. The profit for the accounting year ending on 31st December, 2016 amounts to ₹16,000. Calculate the share of the deceased partner in profits of the firm.

Solution:

Profit for the year is ₹16,000

Profit from 1st January to 1st April, 2016 *i.e.,* for 3 months.

16,000 × 1/4 = ₹4,000

C's share will be 4,000 × 1/5 = ₹800.

2. **Sales basis** The deceased partner's share in profits up to the date of his death can be determined on the basis of sales.

Illustration 11.10. *A, B* and *C* are sharing profits in the ratio of 2 : 2 : 1. *C* dies on April 1, 2017. Sales for the year 2017 amount to ₹3,00,000 out of which sales of ₹1,00,000 amounted between the period from January 1, 2017 to April 1, 2017. The profit for the year amounted to ₹30,000.

Calculate the deceased partner's share in the profits of the firm.

Solution:

The profit up to the death on the basis of turnover:

$$30{,}000 \times \frac{1{,}00{,}000}{3{,}00{,}000} = ₹10{,}000$$

C's share will be:

10,000 × 1/5 = ₹2,000.

In both cases the share of the deceased partner can also be ascertained on the basis of firm's past performance instead of actual figures for the current year.

NOTES

Check Your Progress

4. What happens to the estate of a partner who is deceased?
5. State the two methods through which ascertainment of the deceased partner's share in the profit of the firm.

11.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Section 32 of the Partnership Act deals with the statutory provisions relating to retirement of a partner from partnership firm.
2. The journal entry which should be passed in case it is desired that only retiring partner should be credited with his share in reserves or undistributed profit is:

   Reserves or P&L A/c Dr.

   To Retiring Partners' Capital A/c

   (Only with his share)
3. The journal entry for continuing partners agree to bring cash to pay off the retiring partner will be:

   Bank Dr.

   To Continuing Partners' Capital A/c

   (For cash brought in by the partners in the agreed ratio to pay off the retiring partner)
4. Where under a contract between the partners the firm is not dissolved by the death of a partner, the estate of the deceased partner is not liable for any act done or liability incurred after his death. No public notice is required for this purpose.
5. The two methods through which ascertainment of the deceased partner's share in the profit of the firm are: time basis and sales basis.

11.5 SUMMARY

- Section 32 of the Partnership Act deals with the statutory provisions relating to retirement of a partner from partnership firm.
- A partner may retire from the firm:
  - (a) in accordance with an express agreement; or
  - (b) with consent of all other partners; or
  - (c) where the partnership is at will1, by giving a notice in writing to all the other partners of his intention to retire

- The accounting problems in the event of retirement of a partner can be put as follows:
  - (i) Adjustment for Goodwill.
  - (ii) Revaluation of assets and liabilities.
  - (iii) Adjustment regarding Reserves and other undistributed profits.
  - (iv) Adjustments regarding profit sharing ratios.
  - (v) Payment to the retiring partner.
- The retiring partner will be entitled to his share of goodwill in the firm. The problem of goodwill can be dealt in the following two different ways: (a) Where goodwill account is already appearing in the books and (b) Where goodwill account is not appearing in the books.
- For revaluation of assets and liabilities in case of a retiring partner: Profit and Loss Adjustment account will be opened in the firm's books and profit or loss on revaluation will be credited or debited to all the partners (including the retiring partner) in the old ratio. The assets and liabilities will appear at the revised values in the new balance sheet after retirement.
- In case of Reserves and other Undistributed Profits of a retiring partner, the amount standing as reserves or undistributed profits in the books of the firm will be distributed among all the partners in their old profit sharing ratio.
- In the absence of any other agreement between the partners, the continuing partners will continue to share the profits or losses in between themselves in the same ratio in which they were sharing before retirement of a partner.
- The amount due to the retiring partner will be paid as per terms of the partnership agreement or as otherwise mutually agreed. When the amount payable to the retiring partner is determined, it will be transferred to his loan account.
- The amount due to the retiring partner may be agreed to be paid in equal instalments together with interest at the agreed rate. In such a case there may be two situations:
  - (i) Equal instalments may only be regarding 'principal' amount. Interest on outstanding balance is paid in addition to the instalment amount
  - (ii) Equal instalment may be both as regards interest as well as principal. In such a case the amount of instalment is calculated with the help of Annuity Table

- According to Section 35 of the Partnership Act, a partnership firm may not be dissolved on the death of a partner. Where under a contract between the partners the firm is not dissolved by the death of a partner, the estate of the deceased partner is not liable for any act done or liability incurred after his death. No public notice is required for this purpose.
- In the event of death of a partner, the legal representatives of the deceased partner will be entitled to get from the firm, amounts due on account of following:
  - (i) Capital standing to the credit of the deceased partner on the date of his death.
  - (ii) Share of goodwill.
  - (iii) Profit on revaluation of assets and liabilities as reduced by any loss on any such revaluation.
  - (iv) Share out of the proceeds of a joint life insurance policy.
- The actual share of the deceased partner in the profit of the firm till the date of death can be calculated only by preparing the final accounts up to that date. However, it may not be very convenient. The profit may, therefore, be calculated according to any of the following methods: Time basis and Sale basis.

11.6 KEY WORDS

- **Gaining Ratio:** The term is generally used in case of retirement or death of a partner. It is the ratio in which the continuing partners gain on retirement or death of a partner.
- **Amalgamation:** It refers to the merger of two or more partnership firms to form a new partnership firm.

11.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the conditions under which a partner retires from the firm?
2. State the rights which are not provided to the retiring partner in case he wants to carry on business competing with that of the firm and may advertise such business.
3. Explain the revaluation of assets and liabilities in case of a retiring partner.
4. Explain the condition of payment in installments in case of a retiring partner with journal entries.

5. How can a partner retire from a partnership firm? Is a retiring partner liable for liabilities incurred by the partnership firm after his retirement?
6. State the rights of an outgoing partner in case the continuing partners do not settle his accounts and continue to carry on business.

Long Answer Questions

1. Discuss how goodwill is settled in case of a retiring partner.
2. Explain the accounting entries which are to be made in case of the death of a partner.
3. State the journal entries that are to be passed in the event of amalgamation in the books of (i) the firms to be amalgamated and (ii) New firm.

11.8 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.

BLOCK - IV

COMPANY ACCOUNTS

NOTES

UNIT 12 DEPRECIATION ACCOUNTING

Structure

12.0 Introduction
12.1 Objectives
12.2 Depreciation: Meaning, Need and Cause
  12.2.1 Causes of Depreciation
  12.2.2 Basic Features of Depreciation
  12.2.3 Meaning of Depreciation Accounting
  12.2.4 Objectives of Providing Depreciation
  12.2.5 Fixation of Depreciation Amount
  12.2.6 Methods of Recording Depreciation
12.3 Methods for Providing Depreciation
12.4 Answers to Check Your Progress Questions
12.5 Summary
12.6 Key Words
12.7 Self Assessment Questions and Exercises
12.8 Further Readings

12.0 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.

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".

NOTES

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.

12.1 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

12.2 DEPRECIATION: MEANING, NEED AND CAUSE

In this section, we will study the meaning, need, features and causes of depreciation.

12.2.1 Causes of 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.

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.

12.2.2 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."

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.

12.2.3 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.

12.2.4 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

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.

NOTES

12.2.5 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.

12.2.6 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

NOTES

(*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:

(*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?

12.3 METHODS FOR PROVIDING DEPRECIATION

The following are the various methods for providing depreciation:

1. Uniform charge methods
   (*a*) Fixed instalment method
   (*b*) Depletion method
   (*c*) Machine hour rate method
2. Declining charge or accelerated depreciation methods:
   (*a*) Diminishing balance method
   (*b*) Sum of years digits method
   (*c*) Double declining method
3. Other methods:
   (*a*) Group depreciation method
   (*b*) Inventory system of depreciation
   (*c*) Annuity method
   (*d*) Depreciation fund method
   (*e*) Insurance policy method.

1. Uniform Charge Methods

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.

(*a*) **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 12.1. 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.

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 12.2. 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

NOTES

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				

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.

2. Declining Charge Depreciation Methods

NOTES

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 following methods fall in this category.

(*a*) **Diminishing balance method** According to this 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.

NOTES

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 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 12.3. 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

(*b*) **Sum of years digits (SYD) method** This 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. The depreciation is calculated according to the following formula:

$$\frac{\text{Remaining Life of the Asset (including the current year)}}{\text{Sum of all the digits of the life of the asset in year}} \times \text{Original Cost}$$

For example, if the cost of an asset is ₹10,000 and it has an effective life of 5 years, the amount of depreciation to be written off each year will be computed as follows:

NOTES

$$1\text{st year} = \frac{5}{1+2+3+4+5} \times 10{,}000 = \frac{5}{15} \times 10{,}000 = \frac{10{,}000}{3} = ₹3{,}333$$

$$2\text{nd year} = \frac{4}{15} \times 10{,}000 = ₹2{,}666$$

$$3\text{rd year} = \frac{3}{15} \times 10{,}000 = ₹2{,}000$$

$$4\text{th year} = \frac{2}{15} \times 10{,}000 = ₹1{,}333$$

$$5\text{th year} = \frac{1}{15} \times 10{,}000 = ₹667$$

(*c*) **Double declining balance method** This method is similar to reducing or declining balance method explained above except that the rate of depreciation is charged at the rate which is twice the straight line rate. While computing this rate two things have been kept in mind :

(*a*) No allowance is to be made for the scrap value of the asset.

(*b*) The total cost should not be reduced by charging the depreciation to an amount lower than the estimated scrap value of the asset.

The method is prevalent in USA and is permitted under the federal tax laws.

Illustration 12.4. A plant having a scrap value of ₹1,000 and life of 5 years was purchased for ₹10,000 in January, 2015. You are required to calculate the amount of depreciation for each of the years according to Double Declining Method.

Solution:

According to the Fixed Instalment Method (without considering the salvage value) the depreciation would amount to ₹2,000 (*i.e.,* ₹10,000, 5 years) each year. The rate of depreciation, therefore, comes to 20%. In case of Double Declining Method the rate of depreciation would be the twice of this rate, *i.e.,* 40%. The amount of depreciation for each year would, therefore, be as follows:

Year	*Book value in the beginning of the year*	*Amount of Depreciation*
1	10,000	4,000
2	6,000	2,400
3	3,600	1,440
4	2,160	860
5	1,300	300*

* The depreciation at 40% comes to ₹520. However, since the value of the asset has not to be reduced below the scrap value of the asset (*i.e.,* ₹1,000), only a sum of ₹300 will be charged by way of depreciation.

The declining charge methods of depreciation are preferred over uniform charge methods of depreciation on account of the following reasons:

(*i*) The total cost for use of the asset is evenly spreaded over the useful life of the asset. Such cost of the use of the asset includes both depreciation and repairs. With the asset growing older, the repairs cost goes on increasing while the amount of the depreciation goes on decreasing. Thus, increase in repairs cost is compensated by decrease in depreciation cost.

(*ii*) The rate of depreciation in case of declining charge methods of depreciation is higher as compared to the rates in case of uniform charge methods of depreciation. Thus, the charge for depreciation in the initial years will be more and this will result in a considerable tax advantage to the business in these years when the demand for funds is also more. Higher depreciation in the initial years is also beneficial because a rupee saved today is much more important than a rupee saved in future. Thus, accelerated depreciation creates a shield that enables the business to retain more resources in the early years than it can be under straight line method. These resources can be reinvested for more profits.

3. Other Methods

The following are some of the other methods of providing depreciation.

(*a*) **Group depreciation method** Under this method all homogeneous assets, generally having similar average life expectancy are grouped together in a single asset category. One summary account is established for each group and original cost of all assets in the group is charged to this account. Depreciation is charged for the group in total and not item by item. The essential features of this method are as follows:

(*i*) A summary account is established for each category of homogeneous assets, *e.g.,*10 motor vehicles owned by a company may be put in one account while 15 typewriters owned by the company may be put in another account.

(*ii*) Depreciation is charged for the group in total at a rate based on expected average service life and scrap values of the assets of the group.

(*iii*) On purchase of an asset the group asset account is debited with cost.

(*iv*) The amount of depreciation is calculated on the balance in the group asset account. It is debited to Depreciation Account (or *P. & L.* Account) and credited to Accumulated Depreciation Account.

(*v*) In case an asset is sold the amount received on account of sale of the asset is credited to group asset account. The difference between the cost of the asset and the sales value is transferred to Accumulated Depreciation Account.

NOTES

It should be noted that no single item of the group can be considered to have a book value. Hence, no gain or loss is recorded on disposal of any item of the group in the normal course of events.

Illustration 12.5. A company purchased 10 identical machines on January 1st at a cost of ₹11,000 each. Each having a zero scrap value and an average life of 5 years. At the end of the 2nd year the company sold one machine for ₹6,000 and purchased another for ₹14,000 in the beginning of the 3rd year.

Journalise the above transaction in the books of the company for the 1st three years.

Solution:

COMPUTATION OF DEPRECIATION RATE

Cost of 10 machines (10 × 11,000)	₹1,10,000
Less. Scrap value	Nil
Depreciation to be written off over 5 years	1,10,000
Yearly Depreciation	22,000
Rate of Depreciation: 20%	

JOURNAL

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
1st Year	Machines A/c	Dr.	1,10,000	
	To Bank			1,10,000
	(For machines purchased)			
	Depreciation A/c	Dr.	22,000	
	To Accumulated Depreciation A/c			22,000
	(For depreciation @ 20% on ₹1,10,000)			
2nd Year	Depreciation A/c	Dr.	22,000	
	To Accumulated Depreciation A/c			22,000
	(For depreciation on ₹1,10,000)			
	Bank A/c	Dr.	6,000	
	Accumulated Depreciation A/c	Dr.	5,000	
	To Machines A/c			11,000
	(Being sale of machine)			
3rd Year	Machines A/c	Dr.	14,000	
	To Bank			14,000
	(Being purchase of Machine)			
	Depreciation A/c	Dr.	22,600	
	To Accumulated Depreciation A/c			22,600
	(Being depreciation of Machines on ₹1,13,000 @20%)			

(*b*) **Inventory system of depreciation** The method is followed in case of those assets which are of small values such as loose tools or where the life of the asset cannot be ascertained with certainty *e.g.,* livestock etc. In case of these assets the depreciation is charged on the following basis:

Cost of the assets in working condition at the beginning of the accounting year	....
Add: Cost of the assets purchased during the accounting year	....
Less: Cost of the assets in working condition at the end of the accounting year	....
Depreciation to be charged	....

NOTES

For example, a firm has loose tools in working condition costing ₹2,000 on 1.1.2016 and purchased during 2015 loose tools of ₹3,000. The cost of the loose tools in working condition on 31.1.2016 is ₹2,000. The amount of depreciation to be charged to the Profit & Loss Account comes to ₹3,000 (*i.e.,* ₹2,000 + 3,000 – ₹2,000).

The following journal entry is passed for recording the amount of depreciation:

Depreciation A/c	Dr.
To Asset Account	

(*c*) **Annuity method** The Fixed Instalment Method and the Reducing Balance Method of charging depreciation ignore the interest factor. The Annuity Method takes care of this factor. Under this method, the depreciation is charged on the basis that besides losing the original cost of the asset, the business also loses interest on the amount used for buying the asset. The term "Interest" here means the interest which the business could have earned otherwise if the money used in purchasing the asset would have been invested in some other form of investment. Thus, according to this method, such an amount is charged by way of depreciation which takes into account not only the cost of the asset but also interest thereon at an accepted rate. The amount of interest is calculated on the book value asset, in the beginning of each year. The amount of depreciation is uniform and is determined on the basis of annuity table.

The following journal entries are passed in case depreciation is charged according to this method.

(*i*) *On purchase of asset:*

Asset Account	Dr.
To Bank	

(*ii*) *For charging interest:*

Asset Account	Dr.
To Interest Account	

(*iii*) For charging depreciation:

Depreciation Account	Dr.
To Asset Account	

Illustration 12.6. A firm purchases a leasehold property for a period of five years for ₹10,000 on 1.1.2013. It decides to write off the lease by Annuity Method presuming the rate of interest at 5% p.a. The Annuity Table shows that the annual amount necessary to write off ₹1 at 5% p.a. is ₹0.230976. You are required to prepare the Lease Hold Property Account for five years and show the net amount to be charged to the Profit & Loss Account for these five years.

NOTES

Solution:

Dr. LEASEHOLD PROPERTY ACCOUNT *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
Jan. 1	To Bank	10,000.00	Dec. 31	By Depreciation	2,309.76
Dec. 31	To Interest	500.00	Dec. 31	By Balance c/d	8,190.24
		10,500.00			10,500,00
2014			2014		
Jan. 1	To Balance b/d	8,190.24	Dec. 31	By Depreciation A/c	2,309.76
Jan. 31	To Interest	409.52	Dec. 31	By Balance c/d	6,290.00
		8,599.76			8,599.76
2015			2015		
Jan. 1	To Balance b/d	6,290.00	Dec. 31	By Depreciation A/c	2,309.76
Dec. 31	To Interest	314.50	Dec. 31	By Balance c/d	4,294.74
		6,604.50			6,604.50
2016			2016		
Jan. 1	To Balance b/d	4,294.74	Dec. 31	By Depreciation A/c	2,309.76
Dec. 31	To Interest	214.74	Dec. 31	By Balance c/d	2,199.72
		4,509.48			4,509.48
2017			2017		
Jan. 1	To Balance b/d	2,199.72	Dec. 31	By Depreciation A/c	2,309.76
Dec. 31	To Interest	110.04			
		2,309.76			2,309.76

Statement showing the amount chargeable to the Profit & Loss Account

Year	*Depreciation (debited)*	*Interest (credited)*	*Net Charge against profits*
2013	2,309.76	500.00	1,809.76
2014	2,309.76	409.52	1,900.24
2015	2,309.76	314.50	1,995.26
2016	2,309.76	214.74	2,095.02
2017	2,309.76	110.04	2,199.72
	11,548.80	1,548.80	10,000.00

(*d*) **Depreciation (or 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.

NOTES

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

(*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.

NOTES

New Asset A/c Dr.
To Bank

Illustration 12.7. 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			

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

NOTES

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

(*e*) **Insurance policy method** The method is similar to the Depreciation Fund Method as explained above. However, instead of investing the money in securities an insurance policy for the required amount is taken. A fixed amount as premium is paid every year. However, this amount will have to be paid in the beginning of each year. At the end of the specified period, the insurance company pays the agreed amount with which the new asset can be purchased.

NOTES

The accounting entries can be put as follows:

(*i*) *First and subsequent years*

In the beginning of the year for insurance premium paid:

Depreciation Insurance Policy A/c Dr.

To Bank

At the end of the year for providing depreciation:

Profit and Loss A/c Dr.

To Depreciation Provision A/c

(with the amount of premium paid)

(*ii*) *At the end of the last year*

On realisation of money from the insurance company:

Bank A/c Dr.

To Depreciation Policy A/c

For transfer of profit on insurance policy:

Depreciation Provision A/c Dr.

To Depreciation Provision A/c

For transfer of accumulated depreciation to the Asset Account:

Depreciation Provision A/c

To Asset A/c

On purchase of new asset:

New Asset A/c Dr.

To Bank

Illustration 12.8. A firm purchases a lease for 3 years for ₹30,000 on 1.1.2014. It decided to provide for its replacement by means of Insurance Policy for ₹30,000. The annual premium is ₹9,500.

On 1.1.2017, the lease is renewed for a further period of 3 years for ₹30,000. You are required to show the necessary Ledger Accounts.

Solution:

LEASE ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
Jan. 1	To Bank	30,000	Dec. 31	By Balance c/d	30,000
2015			2015		
Jan. 1	To Balance b/d	30,000	Dec. 31	By Balance c/d	30,000
2016			2016		
Jan. 1	To Balance b/d	30,000	Dec. 31	By Dep. Provision A/c	30,000

DEPRECIATION PROVISION ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
Dec. 31	To Balance c/d	9,500	Dec. 31	By *P* & *L* A/c	9,500
2015			2015		
Dec. 31	To Balance c/d	19,000	Jan. 1	By Balance b/d	9,500
			Dec. 31	By *P* & *L* A/c	9,500
		19,000			19,000

NOTES

Date	Particulars	₹	Date	Particulars	₹
2016			2016		
Dec. 31	To Lease Account	30,000	Jan. 1	By Balance b/d	19,000
			Dec. 31	By *P* & *L* A/c	9500
			Dec. 31	By Depreciation Insurance Policy A/c	1,500
		30,000			30,000

DEPRECIATION INSURANCE POLICY ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
2014			2014		
Jan. 1	To Bank – (Premium)	9,500	Dec. 31	By Balance c/d	9,500
2015			2015		
Jan. 1	To Balance b/d	9,500	Dec. 31	By Balance c/d	19,000
Jan. 1	To Bank – (Premium)	9,500			
		19,000			19,000
2016			2016		
Jan. 1	To Balance b/d	19,000	Dec. 31	By Bank	30,000
Jan. 1	To Bank – (Premium)	9,500			
Dec. 31	To Profit – (Transferred to Depreciation Provision A/c)	1,500			
		30,000			30,000

LEASE (NEW) ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
2017					
Jan. 1	To Bank	30,000			

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.

12.4 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.

NOTES

12.5 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 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.

NOTES

- 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.

12.6 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.

12.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answers Questions

1. Explain 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. Discuss the merits and demerits of Sinking Fund Method of depreciation.

Long Answers Questions

NOTES

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.

12.8 FURTHER READINGS

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

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

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

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

UNIT 13 COMPANY ACCOUNTS-I

NOTES

Structure

13.0 Introduction
13.1 Objectives
13.2 Meaning and Characteristics of Companies
13.3 Kinds of Companies
13.4 Formation of Companies
13.5 Share Capital
13.6 Undersubscription, Oversubscription and Issue of Shares at Premium and Discount
13.7 Buyback of Shares and Treasury Stock
13.8 Answers to Check Your Progress Questions
13.9 Summary
13.10 Key Words
13.11 Self Assessment Questions and Exercises
13.12 Further Readings

13.0 INTRODUCTION

Joint Stock Companies represent the third stage in the evolution of forms of business organisation. Unlike sole proprietorship and partnership firms, a company enjoys a separate legal status. The ownership is here divorced from the management. The shareholders contribute towards the finances of the company but all of them do not and cannot participate in the management of the company. The company is managed by a Board of Directors elected by shareholders. Thus, in a company form of business organisation, a shareholder simply acts as a supplier of capital. The law applicable to companies in India has largely been based upon the laws of companies in England. An Act for registrations of joint stock companies in India was first passed in 1850 on the pattern of English Companies Act of 1844. The Act was subsequently amended in 1857 and 1860. This Act of 1850 was replaced by the Companies Act of 1913. The Act was also amended several times between 1936 and 1956. However, all these amendments proved inadequate. As a result as per the recommendation of C.H. Bhabha Committee, the Companies Act of 1956 was enacted to replace the Companies Act of 1913.

The Companies Act 1956 came into effect from 15th April, 1956. The Act has been amended several times. Some of the important amendments have been in 1960, 1963, 1966, 1969, 1974, 1977, 1981, 1988, 2000, 2001, 2002 and 2006.

However, this piecemeal re-engineering of the corporate regulatory framework was not considered adequate to meet changes in the national and international economic environment and the need to ensure greater autonomy

NOTES

of operation and innovation to corporates. In the above backdrop the review of the Companies Act 1956 and drafting of a new Companies Bill was taken up by the Government. An Export Committee on company law under the chairmanship of Dr. J.J. Irani was constituted on 2nd December, 2004 to make recommendation in respect of new company law.

The process of overhauling the Company Law was taken in right earnest in October, 2008. Finally a comprehensive Companies Bill 2009 was introduced in the Lok Sabha. After meeting several hurdles, the bill was finally passed by both Houses of Parliament on 8th August, 2013. It received the President's assent on 29th August, 2013 and has now become the Companies Act, 2013. The Act has been further amended by The Companies (Amendment) Act, 2015 and The Companies (*A*mendment) Act 2017. The relevant changes have been incorporated at proper places in the book.

13.1 OBJECTIVES

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

- Describe the meaning and characteristics of companies
- Explain the kinds of companies
- Discuss the formation of companies
- Examine the important concepts related to share capital

13.2 MEANING AND CHARACTERISTICS OF COMPANIES

In common parlance, company means, an association of persons formed for the economic gain of its members. However, in law, any association of persons for any common object can be registered as a company. The object need not be the economic gain of its members, *e.g.*, a company can be formed for purposes such as charity, research, advancement of knowledge, etc.

In the words of Justice Lindley, "A company is an association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs, are members." (Late) Chief Justice Marshall of USA has defined a company as "a person, artificial, invisible, intangible and existing only in the eyes of the law. Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence."

The Companies Act 2013, defines a company as "a company incorporated under this Act or an existing company." 'An existing company' means a company formed and registered under any of the former Companies

Act. It is to be noted that some sole proprietorship and partnership firms use the word 'Company' as a part of their names, *e.g.*, Ram & Company, Shyam & Company. Such firms are not companies within the meaning of the Act.

A company thus exists, only in the contemplation of law. It has no physical existence. Right to act as a natural being is granted to it by law. Law creates it and law alone can dissolve it.

Essential Characteristics of a Company

Following are the essential characteristics of a company:

Voluntary association A company is a *voluntary* association of persons, *i.e.*, it can neither compel a person to become its member nor to give up its membership. It is the personal choice of people and their objective to make profits which leads them to become members of a company.

Independent legal entity A company is a legal entity quite distinct and separate from its members. It can hold and deal with any type of property—of which it is the owner—in any way it likes; can enter into contracts, open a bank account in its own name, sue and be sued by its members as well as outsiders.

On account of this *independent corporate existence*, the creditors of a company are creditors of the company alone and their remedy lies against the company and its property only and not against any of its members. Law recognises the existence of the company as quite distinct, irrespective of the motives, intentions, scheme of conduct of the individual shareholders.

Perpetual existence A company has *perpetual succession*. The mode of incorporation and dissolution of a company and the right of the members to transfer shares freely, guarantees the continuity of the existence of the company quite independent of the life of the members. The existence of a company can be terminated only by law. Thus, members may come and go, but the company can go on for ever.

Common seal A company being an artificial entity, acts through other natural persons, who are called directors. They act as agents to the company but not to its members. All the acts of the company are authorised by its common seal. The *common seal* is the official signature of the company. A document not bearing the common seal of the company will not be binding on the company.

The Companies (Amendment) Act, 2015 has removed the requirement of the common seal by amending Section 9 of the Companies Act, 2013. In case a company does not have a common seal, the authorization of any document on behalf of the company can be executed by two directors or by a director and the company secretary, where appointed.

Limited liability The liability of the members of a company is generally *limited* to the extent of the unpaid value of the shares held by them. In the case of a guarantee company, the members are liable to contribute a specified agreed sum to the assets of the company in the event of the company being wound up if its assets fall short of its liabilities.

Transferability of shares The shares of a joint stock company are freely transferable. However, in the case of private companies they are transferable subject to the restrictions put by the company's articles.

13.3 KINDS OF COMPANIES

Let's discuss the various kinds of companies in this section.

1. Statutory Companies

A company formed by a special Act passed either by the Central or State Legislature is called a Statutory Company or a Statutory Corporation. Such companies or corporations are governed by their respective Acts, and are not required to have any Memorandum or Articles of Association. Changes in their structure are possible only by legislative amendments. Annual Report on the working of each such company is required to be placed on the table of the Parliament. The audit of such companies is conducted under the supervision, control and guidance of the Auditor-General of India. These companies are usually formed to carry out some special public undertakings requiring extraordinary powers and privileges. The object of such companies is not so much to earn profit but to serve people. Though the liability of the members of such companies is limited, yet in most of the cases, they may not be required to use the word 'limited' as part of their names. Some of the important statutory companies are Reserve Bank of India, State Bank of India, Nationalised Banks, etc.

2. Registered Companies

Companies formed by registration under the Companies Act are known as Registered Companies. The working of such companies is regulated by the provisions of the Companies Act, Memorandum of Association and Articles of Association. These companies may be limited by shares or limited by guarantee or unlimited companies.

(*i*) **Companies limited by shares.** A company having the liability of its members limited by the amount, if any unpaid on the shares held by them, is called as a company limited by shares [Sec. 2(21)]. For example, if *A* Ltd. has a share capital of 10,000 shares of ₹ 10 each and *A* has purchased 100 shares on which he has paid so far ₹ 6 per share, the maximum liability of *A* is now only ₹ 4 per share (the unpaid amount).

A large majority of companies registered in our country are of this category.

(*ii*) **Companies limited by guarantee.** Companies whose objective is not to earn profits are mostly registered as guarantee companies. A guarantee company is a company in which liability of each member is limited to such amount as he may voluntarily undertake under the memorandum to contribute to meet out the deficiency of the assets of the company in the event of its being wound up [Sec. 2(21)]. The guaranteed amount may differ from member to member. It may or may not have share capital. If the company has share capital, the shareholders shall be liable to pay the amount which remains unpaid on their shares plus the amount payable under the guarantee. The amount guaranteed by each member is in the nature of a reserve capital. It cannot be called up except in the case of the winding up of the affairs of the company. The articles of association of such a company shall state the number of members with which the company is to be registered.

(*iii*) **Unlimited companies.** A company, not having any limit on the liability of its members, is termed as an unlimited company [Sec. (92)].

The Articles of an unlimited company should state the number of members with which the company is to be registered. If it has a share capital, the amount of share capital with which the company is to be registered, should also be stated in the Articles.

The members of an unlimited company are fully liable for the debts incurred by the company like partners of a partnership firm. However, the creditors cannot sue the members directly on account of separate legal personality of the company. In case the company fails to pay, the creditors will have to resort to the winding up of the company. The liquidator will call upon members to contribute towards the assets of the company so as to enable him to meet the debts and the cost of winding up of the company.

An unlimited company may or may not have any share capital. In case it has any share capital, it can increase or reduce its share capital without any restriction. It may even purchase its own shares.

Such type of companies, though permitted by the Companies Act, are not common in the country.

A registered company (whether limited or unlimited) may be either a private or a public company.

NOTES

(*a*) *Private company: A* private company means, a company which has a minimum paid up capital as may be prescribed[1], and which by its Articles:

(*i*) restricts the right to transfer its shares*.

(*ii*) except in case of one person company limits the number of members to 200 not including:

(*a*) persons who are in the employment of the company and;

(*b*) persons who having been formally in the employment of the company who are members of the company while in that employment and have continued to be members after that employment ceased.

(*iii*) prohibits any invitation to the public to subscribe for any securities of the company [Sec. 2(68)].

(*b*) *Public company:* A public company means a company which:

(*i*) is not a private company and

(*ii*) has a minimum paid up capital as may be prescribed.

Provided that a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles; [Sec. 2(71)].

It will be noted that a private company can be registered with only 2 members (*e*xcept one person company) while a public company needs at least 7 members. Where 2 or more members hold 1 or more shares jointly, they shall be considered as a single member.

Listed and Unlisted Companies

A public company may further be categorized into a listed and an unlisted company. According to the Companies Act, 2013, listed company means "a company which has any of its securities listed on any recognized stock exchange" [Sec. 2(52)]. Alternatively, the company may be unlisted, *i.e.,* a company whose shares are not listed on a stock exchange. A public company may be listed or unlisted. It will be listed if it has issued securities to public which are listed on one or more recognized stock exchanges. It will be

[1&2]As amended by The Companies (Amendment) Act, 2015. At present there is no minimum capital requirement prescribed both for a public company and a private company.

*The right to transfer shares is generally restricted in the following manner:

- The directors are authorised under the Articles to refuse transfer of shares to those whom they disapprove.
- The shareholders may be required to offer their shares first to existing shareholders in case they intend to transfer shares.
- The method of calculating the price at which the shares are to be sold by one shareholder to another may be prescribed in the Articles
- It may be provided that shareholders who are the employees of the company shall offer share to specified persons or class of persons in case they leave the company's employment.

unlisted if it has not offered its securities to the general public and hence not got them listed on a recognized stock exchange. However, a private company will always be unlisted since it cannot invite the general public to subscribe for its securities.

Listing of the securities on a stock exchange makes them readily marketable since such securities can be freely purchased and sold on the stock exchange.

The listed company has to follow guidelines of *SEBI,* in addition to provisions of Companies Act, Public company which is not listed does not have to follow *SEBI* guidelines.

3. Holding Company

"In relation to one or more other companies, means a company of which such companies are subsidiary companies; [Sec. 2(46)]." The expression company here includes any body corporate[3].

In other words a holding company can be there only when it has a subsidiary company or companies.

Subsidiary Company or Subsidiary: In relation to any other company (that is to say the holding company); means a company in which the holding company-

(*i*) controls the composition of the Board of Directors; or

(*ii*) exercises or controls more than one-half of the total voting power either at its own or together with one or more of its subsidiary companies.

Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.

Explanation - For the purposes of this clause,-

(*a*) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (*i*) or sub-clause (*ii*) is of another subsidiary company of the holding company;

Example: Company *B* is a subsidiary of Company *A* and Company *C* is a subsidiary of company *B*. Hence, company *C* is a subsidiary of Company *A*. By virtue of the above provision, if company *D* is a subsidiary of Company *C*, Company *D* will be subsidiary of Company *B* and consequently also of Company *A*.

(*b*) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;

[3] Added by The Companies (Amendment) Act, 2017.

(*c*) the expression "company" includes anybody corporate;

(*d*) "layer" in relation to a holding company means its subsidiary or subsidiaries; [(Sec. 2(87)].

NOTES

4. Government Company

It means any company in which not less than fifty-one per cent of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company; [(Sec. 2(45)]."

5. Foreign Company

It means any company or body corporate incorporated outside India which—

(*a*) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(*b*) conducts any business activity in India in any other manner [Sec. 2(42)].

A foreign company is required to register with Registrar of Companies within 30 days from the date of establishing a place of business in India.

6. One-Man Companies or Family Companies

A private company can be formed with two members and a public company with seven. A man may take only one other person with him to constitute the minimum number required in a private company or six other so as to constitute the required seven in a public company. He may keep with himself a substantial number of shares so as to have controlling power over the company. Such a company may be regarded as One-man Company. Sometimes, a company may be formed by a person by involving other family members. Such a company can be regarded as a 'Family Company'. Even in such cases the company will be regarded to have a separate entity as distinct from the majority shareholders (*Salomon v. Salomon & Co. Ltd.).*

The Companies Act, 2013 has introduced the concept of "One Person Company" in the true sense. According to clause 2(62) of the Act "One Person Company" (OPC) means a company which has only one person as a member.

A one person company can be formed as a private company by one person subscribing to the Memorandum and complying with all other usual legal requirements.

The following are some specific requirements applicable to "One Person Company":

1. The words "One Person Company" shall be mentioned in brackets below the name of such company wherever the name is printed affixed, or engraved.

2. The memorandum of "One Person Company" shall indicate the name of other person, with his prior written consent in the prescribed form, who shall, in the event of the subscriber's death become the member of the company. The written consent of such person shall also be filed with the Registrar at the time of incorporation of the One Person Company along with its Memorandum and Articles.

   Provided further that such other person may withdraw his consent in such manner as may be prescribed.

   Provided also that the member of "One Person Company" may at any time change the name of such other person by giving notice in such manner as may be prescribed.

3. It shall be the duty of the member of "One Person Company" to intimate the company the change, if any, in the name of the other person nominated by him by indicating in the memorandum or otherwise within such time and in such manner as may be prescribed, and the company shall intimate the Registrar any such change within such time and in such manner as may be prescribed.

7. Small Company

A small company means a company other than a public company which satisfies any of the following two conditions:

(*i*) Its paid-up share capital does not exceed fifty lakh rupees or such higher amount as may be prescribed by the Central Government, not exceeding ten crore rupees.[4]

(*ii*) Its turnover as per last profit and loss account for the immediately preceding financial year does not exceed two crore rupees or such higher amount as may be prescribed by the Central Govt., not exceeding one hundred crore rupees. [Sec. 2(85)]. [5]

8. Dormant Company

An inactive company is termed as a dormant company. Section 455 of the Companies Act, 2013 makes the following provision regarding dormant companies.

(*i*) Where a company is formed and registered under 2013 Act for a future project or to hold an asset or intellectual property and has no significant accounting transaction, such a company or an inactive company may make an application to ROC to obtain the status as a "dormant company".

(*ii*) "Inactive Company" means a company which has not been carrying on any business or operation, or has not made any significant accounting

[4] Raised from ₹ 5 crore by The Companies (Amendment) Act 2017.

[5] As amended by The Companies (Amendment) Act 2017.

transaction during the last 2 financial years, or has not filed financial statements and annual returns during the last 2 financial years.

(*iii*) Cash flow statement is not required for a dormant company.

(*iv*) Board meetings required to be held at least in each half of a calendar year not the gap between the 2 meetings is not less than 90 days.

(*v*) The dormant company may become an active company by making necessary application to ROC.

(*vi*) The ROC may strike off the name of a dormant company from the register of dormant companies, if the company fails to comply with the requirements.

9. Associate Company

In relation to another company, it means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company. [Sec. 2 (6)].

"Significant influence" here means control of atleast 20% of total voting power or control of or participation in business decisions under any agreement.

10. Global Company

A company which plans its activities on a global basis but markets its products through the use of some co-ordinated image brand in all markets. There is generally one corporate office that is responsible for global strategy. Such company integrates all of its units and focuses its marketing strategy on worldwide scale. For example, a global software company would sell the same operating system in all countries, but makes a few changes to program to account for foreign language speakers. It makes the product homogenous to the maximum extent which allows the company to have the benefits from saving on activities such as R&D, production and marketing etc.

11. Multinational Company

A company which is having its headquarters in one country but have business operations in other countries. This means this type of organisation will have business operations in many countries.

A multinational company technically differs from a global company. A multinational company does not have, like a global company, co-ordinated product offerings in each country. Its focus is more on adapting its products or services to each individual market. For example, Toyota Motors is a multinational company having its base in Japan. However, it assembles cars in different countries keeping in view the local requirements and regulations.

NOTES

It may be noted that neither the political scientists nor economists have a standard definition for a multinational company or a global company. In practical terms, people tend to call any company that sells products or services on the global market or has operations in several countries a multinational or a global company. Hence, the two terms can be used interchangeably to a large extent.

12. Charitable or Non-Profit Making Companies

A company may be formed for a charitable or non-profit making objective under Section 8 of the Companies Act. Such a company may be registered with a limited liability without requirement of using the words 'limited' or 'private limited' as a part of its name. The Central Government may issue a license to that effect if it is satisfied that an association:

(*i*) is about to be formed as a limited company for promoting commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other useful object, and

(*ii*) intends to apply its profits if any or other income in promoting its objects, and

(*iii*) intends to prohibit the payment of any dividend to its members.

Such an association can be registered as a company by complying with all the other requirements of the Companies Act required for formation of a company.

Of course, it may not use the word 'limited' or 'private limited' as a part of its name because of the license so granted by the Central Government.

Check Your Progress

1. State the meaning of perpetual existence in relation to companies.
2. Define an inactive company.

13.4 FORMATION OF COMPANIES

A company may be formed either to take over an existing business or to carry on a new business. Whatever may be the objective, the procedure for the formation of a company, from the time the idea of forming a company is first conceived till the company is actually formed and commences business, may be divided into three principal stages:

(*i*) Promotion.

(*ii*) Incorporation.

(*iii*) Commencement of business.

Let's discuss promotion and incorporation briefly in this section.

NOTES

Promotion

The stage of conceiving an idea and its working up is termed as promotion. The person involved in this task is termed as promoter. The promoter may work up the idea with the help of his own resources, influence or competence or he may, if necessary, take the help of technical experts to find out the economics of the project he has in his mind.

Promoter

The Companies Act, 2013 defines a promotes as under:

"Promoter means a person—

(*a*) who has been named as such in a prospectus or is identified by the company in the annual return referred to in Section 92[6]; or

(*b*) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or

(*c*) in accordance with whose advice, directions or instructions the Board of Directors of the company in accustomed to act.

Provided that nothing in sub-clause (*c*) shall apply to a person who is acting merely in a professional capacity. [(Sec. 2(69)].

Promoter is, as a matter of fact, a person who conceives the idea of starting a business, plans the formation of a company and actually brings it into existence. He opens out the opportunities for profitable investment. He may be said to be "the father of the company who sees the prospects of gain in a business which he wishes to set up, and believes that he can persuade others to think as he does." In other words the function of the promoter, may be defined as "the discovery of business opportunities and the subsequent organisation of funds, property and managerial ability of a business concern for the purpose of making profits therefrom." Palmer has defined company promoter as "a person who originates a scheme for the formation of the company, has the Memorandum and the Articles prepared, executed and registered, and finds the first directors, settles the terms of preliminary contracts and prospectus (if any) and makes arrangements for advertising and circulation of the prospectus and placing the capital".

Thus, a promoter discovers, formulates and assembles a business proposition and brings about a company into existence for its development. He plans and decides upon the nature, scope and the extent of the business for the proposed company. He provides or secures the initial capital of the company, negotiates the purchase of an existing business, instructs and directs the solicitors or lawyers to prepare the necessary documents, selects and arranges with persons to become directors, has the prospectus approved and

[6] Every company has to prepare and file a Return in the prescribed form containing the particulars as they stood on the close of the financial year giving vital details of the company.

issued, induces persons to buy shares, finds funds for the registration fees and executes a score of other things involved in the formation of a company.

Incorporation

It is the incorporation which brings a company into existence as a separate corporate entity. The promoter has to take the following preliminary steps in this connection:

(*i*) **Ascertainment of availability of the proposed name of the company:** This has to be confirmed from the Registrar of Companies. Application has to be made in the prescribed form with the prescribed fee. It will be better for the promoters to select and send to the Registrar three or four names in order of preference.

(*ii*) **Application for licence:** In case the industry to be run by the proposed company falls within the category of those industries for the establishment of which licence is necessary under the Industries (Development & Regulation), Act, 1951, the application should be made to the concerned ministry of the Central Government.

(*iii*) **SEBI's approval to Draft Prospectus:** In case a company proposes to raise capital by issue of shares or debentures to the general public, a draft prospectus has to be submitted to the Securities and Exchange Board of India (SEBI) duly certified by a merchant banker acting as a lead banker to the issue regarding compliance of all legal formalities.

(*iv*) **Prepare and finally get printed the company's memorandum and articles of association.**

(*v*) **Fixation of the underwriters, brokers, solicitors, auditors, etc.**

In addition to the above preliminary steps the promoter will have to take the following steps to get the company incorporated:

1. Filing of the necessary documents.
2. Payment of the necessary fees.
3. Obtaining the certificate of incorporation.

13.5 SHARE CAPITAL

Meaning: A share is one of the units into which the total share capital of a company is divided. The Companies Act, 2013 defines a share as "share in the share capital of a company and includes stock". [Sec. 2(84)].

Essential Features: The following are the essential features of a share:

1. A share has a nominal value and bears a distinct number.
2. A share certificate issued under the common seal of the company certifies that the person named herein is a registered holder of a

specific number of shares bearing distinct numbers as mentioned in the certificate.

3. A share is an ownership security. In other words, a shareholder is a part-owner of the company.
4. A share is said to be a bundle of rights as well as liabilities. It secures to its owner the right to receive a proportionate part of the profits, if any, and proportionate part of the assets of the company upon liquidation. On the other hand the shareholder may also be required to pay the full value in winding up.
5. Shares may be issued generally at par or premium and at discount only in certain cases.
6. A share is considered to be a movable property transferable in the manner provided in the articles of the company [Sec. 44].

Stocks

Fully paid up share capital may, if the Articles so permit, be converted into stock by an ordinary resolution (a resolution by simple majority) of the members. Stock is the aggregate consolidated holdings of the share capital of a person. It can be divided and transferred in any fractions and sub-divisions without regard to the original face value of the share for the purpose of convenient holding into different parts.

Difference between a Share and a Stock

(1) A share may not be fully paid up, but a stock is always fully paid up.

(2) A share has a nominal value, whereas a stock has no nominal value.

(3) A share cannot be transferred in small fractions, while a stock can be transferred in any fractions.

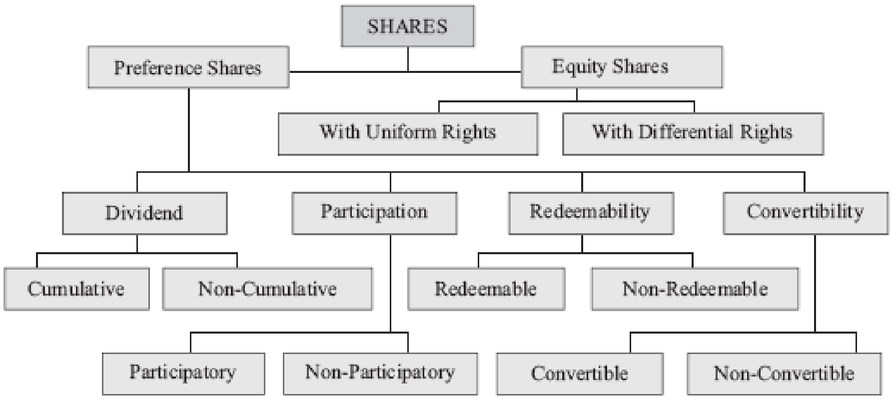
(4) All shares bear distinct numbers, while stocks disclose the consolidated value of the share capital. Fractions of the stock do not bear any number.

(5) All shares are of equal denomination. Stock may be of unequal amounts.

(6) Unlike shares, stock cannot be directly offered by the company to the public in the first instance. Only fully paid up shares can be converted into stock by the company.

Types of Shares

Shares can be of different types as given in the following chart:



NOTES

Each of the above types of shares are being explained in the following pages.

1. Preference Shares

Preference shares are those which carry the following preferential rights over other classes of shares:

(*a*) A preferential right in respect of a fixed dividend—it may consist of a fixed amount (say ₹ 30,000 p.a.) or a fixed rate (say 13% p.a.)

(*b*) A preferential right as to repayment of the capital in the event of company's winding up.

Categorisation and Type of Preference Shares Preference shares can be categorised variously. Their categories and the types under each category are shown below:

On the Basis of Dividend

(*i*) **Cumulative preference shares.** In case of shares, arrears of dividend go on accumulating till they are paid. The accumulated arrears of dividend shall be paid before anything is paid out of profits to the holders of any other class of shares. Preference shares are always cumulative unless otherwise expressly stated in the company's articles.

Example 1: A company has 10,000, 12% preference shares of ₹100 each. The company has not paid dividend to its preference shareholders for the year 2012-13 and 2013-14. In 2014-15 the company earns adequate profits. In this case the company shall pay dividend for 3 years (including arrears of last 2 years) amounting to ₹3,60,000 (₹1,20,000 per annum) before paying any dividend to the equity shareholders.

(*ii*) **Non-cumulative preference shares**. In case of these shares dividend is not allowed to accumulate. The right to claim dividend will lapse if there are not sufficient profits in a particular year.

Example 2: In Example 1 if the preference shares are non-cumulative the company will pay dividend only for 2014-15 amounting to ₹1,20,000 to its preference shareholders before paying any dividend to its equity shareholders.

NOTES

On the Basis of Participation

(*i*) **Participating preference shares.** The holders of these shares are entitled to (*a*) a fixed dividend and (*b*) a share in the surplus profits, remaining after paying dividend to the equity shareholders up to a certain limit.

Example 3: A company has 10,000, 10% preference shares of ₹100 each and 1,00,000 equity shares of ₹10 each. The Articles provide that after paying a dividend at 15% to the equity shareholders, the remaining profits will be dividend in equally between Preference Shareholders and Equity Shareholders. The company makes a profit of ₹5,00,000 in the year 2014-15. The division of profit among the preference and equity shareholders will be as under:

	₹
Preference Shareholders at 10% on ₹10,00,000	1,00,000
Equity Shareholders at 15% on ₹10,00,000	1,50,000
	2,50,000

The balance of profit of ₹2,50,000 will be divided between Preference and Equity shareholders equally. Thus, the total share of different shareholders in the company's profits for 2014-15 will be as under:

	₹
Preference Shareholders (1,00,000 + 1,25,000)	2,25,000
Equity Shareholders (1,50,000 + 1,25,000)	2,75,000
	5,00,000

(*ii*) **Non-participating preference shares.** The holders of these shares are entitled to a fixed dividend and not a share in the surplus profits.

Example 4. In Example 3 if the preference shares and non-participating the profit of ₹5,00,000 made by the company during 2014-15 will be divisible between preference shareholders and equity shareholders as under:

	₹
Preference Shareholders at 10%	1,00,000
Equity Shareholders (5,00,000 – 1,00,000)	4,00,000
	5,00,000

On the Basis of Convertibility

(*i*) **Convertible preference shares.** The holders of these shares to get their preference shares converted into equity shares within a certain period.

(*ii*) **Non-convertible preference shares.** These preference shares do not carry the right of conversion into equity shares.

On the Basis of Redemption

(*i*) **Redeemable preference shares.** The shares which can be redeemed after a fixed period or after giving the prescribed notice, as desired by the company.

(*ii*) **Irredeemable preference shares.** Shares which cannot be redeemed during the life-time of the company.

However, as per the Companies Act, 2013 a company can issue only such preference shares which are redeemable within 20 years from the date of issue. However, Preference Shares which are issued for infrastructure projects can be redeemable after a period exceeding 20 years.

Of course, in no case a company can issue irredeemable preference shares.

It may be noted that preference shares are always taken as cumulative, non-participating, non-convertible and redeemable, unless otherwise specified.

2. Equity Shares

Equity shares are those shares which are not preference shares. Equity shares can be of two types:

(*i*) With voting rights;

(*ii*) With differential right as to dividends, voting or otherwise in accordance with the rules and subject to such conditions as may be prescribed. [Sec. 43(*a*)]

Rules as to Issue of Equity Shares with Differential Rights

The following are the basic rules notified by the Ministry of Corporate Affairs for issue of shares with differential rights:

(*a*) The articles of association of the company authorizes the issue of shares with differential rights.

(*b*) The issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders.

(*c*) The shares with differential rights shall not exceed twenty-six percent of the total post-issue paid up equity.

(*d*) The company should have consistent track record of distributable profits for the last three years.

(*e*) The company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution or a scheduled bank.

Check Your Progress

3. Define stock.
4. What are the two types of equity shares?

NOTES

13.6 UNDERSUBSCRIPTION, OVERSUBSCRIPTION AND ISSUE OF SHARES AT PREMIUM AND DISCOUNT

In this section, we will discuss the concepts of undersubscription, oversubscription and issue of shares at premiums and discount.

Undersubscription

A company may not receive applications for all the shares offered by it to the public. For example, it might have offered 8,000 shares to the public but applications might have been received only for 6,000 shares. Such a situation is called under subscription. In such a case entries for application, allotment and calls will be made only for 6,000 shares.

However, if the shares are so undersubscribed that applications are not received even for minimum subscription, the company cannot proceed with allotment. It will have to refund to the applicants all application money.

Oversubscription

A company, making a public offer, may receive applications for a larger number of shares than offered by it to public for subscription. Such a situation is termed as oversubscription. The company may treat the excess applications received in one or more of the following ways:

(*i*) Certain applications (either on the basis of number of shares applied for or any other basis) may straightway be rejected. Application money will be refunded to such applicants. The journal entry will be

Share application A/c *Dr.*

To Bank A/c

(Being refund of application money to applicants for…shares @ ₹ …per share)

(*ii*) Partial allotment may be done. It means allotment of a smaller number of shares than the number applied for. For example every applicant for 1,000 shares may be allotted 500 shares and every applicant for 2,000 shares be allotted 800 shares and so on.

(*iii*) Pro rata allotment may be done. It means allotment is made to each applicant or some applicants on a proportionate basis. For example a company offers 10,000 shares to the public, and applications are received for 15,000 shares. No allotment is made to applicants for 3,000 shares and the rest are allotted shares on a pro rata basis. It means applicants for 12,000 shares have been allotted 10,000 shares or every applicant of this group has been allotted five shares for six applied.

In case the company adopts (*ii*) or (*iii*) alternative, there will be a problem of excess application money received. Company can use the excess application money received, for money due on allotment. For example, *A* applies for 50 shares and pays ₹ 2 per share as application money. He gets only 40 shares and the money due on allotment is ₹ 3 per share. The following journal entry will be passed for transferring money from "*share application account" to "share allotment account"*.

Share application A/c	Dr.	20
To Share allotment A/c		20

Surplus money exceeding that due on allotment should be refunded to the allottees, within 15 days from the date of closure of issue or such lesser time as may be specified by *SEBI*. In case of default, as discussed earlier, the applicant will be entitled to interest at 15% p.a. for the delayed period besides penalty on both the company and the directors.

Illustration 13.1. A company offers 10,000 shares of ₹ 10 each to the public for subscription. The money is payable as follows:

₹ 2 on Application, ₹ 3 on Allotment, and ₹ 5 on First & Final Call.

The company receives application for 12,000 shares. Applicants for 9,000 shares pay the application money in cash, while the rest pay that money through stockinvests. The shares are allotted on the *prorata* basis. All allottees pay the allotment and final call moneys on due dates.

Pass the necessary journal entries.

Solution:

Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Bank A/c	*Dr.*	18,000	
	To share application A/c			18,000
	(Being application money received in cash on 9,000 shares @ ₹ 2 per share)			
	Share application A/c	*Dr.*	18,000	
	To Share capital A/c			15,000
	To Share allotment A/c			3,000
	(Being transfer of application money due on 7,500 shares from applicants who applied for 9,000 shares. Surplus application money adjusted towards allotment)			
	Bank A/c	*Dr.*	5,000	
	To Share capital A/c			5,000
	(Being application money received on 2,500 shares @ ₹ 2 each from persons who applied through stockinvests)			
	Share allotment A/c	*Dr.*	30,000	
	To Share capital A/c			30,000
	(Being allotment money due on 10,000 shares @ ₹ 3 per share)			
	Bank A/c	*Dr.*	27,000	
	To Share allotment A/c			27,000

NOTES

Date	Particulars	Dr. ₹	Cr. ₹
	(Being allotment money received on 10,000 shares)		
	Share first & final call A/c Dr. To Share capital A/c (Being 1st & final call money due on 10,000 shares @ ₹ 5 per share)	50,000	50,000
	Bank A/c Dr. To Share first & final call A/c (Being receipt of first & final call money)	50,000	50,000

Calls in advance

A company may, if authorised by its Articles, accept calls in advance from its shareholders. Table *F* gives such a power and also provides for payment of interest at a rate not exceeding 12% per annum. The amount received in advance as payment of calls will be credited to a "Calls in Advance Account." The amount so received will be adjusted towards the payment of calls as and when they become due.

Bank A/c Dr.
To Call in advance A/c
(with the amount of calls received in advance)
Share ...... call A/c
To Share capital A/c
(with the amount due on........call on all shares including those on which call has been received in advance)
Bank A/c Dr.
(with the amount actually received)
Calls in advance A/c Dr.
(with the amount of the call received in advance)
To........call A/c

Calls in Arrears

A shareholder may not pay the call when it becomes due. The company may provide in its Articles for charging interest from the defaulting shareholder. Table *F* permits charging of interest on calls in arrears at 10% per annum. The journal entries in respect of calls in arrears are as follows:

When a call becomes due:

Share........call A/c Dr.
To Share capital A/c

When money in response to calls is received

Bank A/c Dr.
To Share........call A/c
(with the amount actually received excluding the amount of a call in arrear)

At the end of the accounting year, the amount outstanding on account of a call will be transferred to 'Calls in Arrears A/c'.

Calls in arrears A/c Dr.
To Share........call A/c

In case a shareholder makes payment of a 'call in arrear' with interest, the entry will be:

Bank A/c Dr.
To Share........call A/c/Calls in arrears A/c
To Interest A/c

Illustration 13.2. A company offers 10,000 shares to the public. The amount payable is as follows:

On Application	₹ 3 per share	On 1st Call	₹ 3 per share
On Allotment	₹ 2 per share	On Final Call	₹ 2 per share

Applications are received for 15,000 shares. The directors make the allotment as follows:

(*i*) No allotment to applicants for 3,000 shares.
(*ii*) Rest allotted on a pro rata basis.

All calls were duly made and paid except:

- *A*, a holder of 100 shares paid the two calls with allotment.
- *B*, a holder of 200 shares fails to pay the 1st and the 2nd calls.
- *C*, a holder of 100 shares fails to pay the 2nd call.

Pass the necessary journal entries to record the above transactions in the company's books and show how the share capital will appear in the company's Balance Sheet.

Solution:

Journal Entries

Date	*Particulars*		₹ *Dr*	₹ *Cr*
	Bank A/c	*Dr*	45,000	
	To Share application A/c			45,000
	(Being application money received on 15,000 shares @ ₹ 3 per share)			
	Share application A/c	*Dr*	45,000	
	To Bank			9,000
	To Share allotment A/c			6,000
	To Share capital A/c			30,000
	(Being transfer of application money to Share capital A/c on 10,000 shares, surplus money on pro rata allotment to share allotment account and the balance being refunded)			
	Share allotment A/c	*Dr*	20,000	
	To Share capital A/c			20,000
	(Being money due on allotment)			
	Bank A/c	*Dr*	14,500	
	To Share allotment A/c			14,000
	To Calls in advance A/c			500
	(Being receipt of allotment and calls in advance money)			
	Share 1st call A/c	*Dr*	30,000	
	To Share capital A/c			30,000
	(Being money due on 1st call)			
	Bank A/c	*Dr*	29,100	
	Calls in advance A/c	*Dr*	300	
	To Share 1st call A/c			29,400
	(Being receipt of money on 1st call)			
	Share second & final call A/c	*Dr*	20,000	
	To Share capital A/c			20,000
	(Being money due on 2nd call)			

NOTES

Date	Particulars		₹ Dr	₹ Cr
	Bank A/c	Dr	19,200	
	Calls in advance A/c	Dr	200	
	To Share 2nd call A/c			19,400
	(Being money due on 2nd call)			
	Calls in arrears A/c	Dr	1,200	
	To Share 1st call			600
	To Share final call			600
	(Being transfer of 1st and final call in arrear to calls in arrears account)			

......Co. Ltd.

Balance Sheet (Extracts)

as on…..

Equity & liabilities	Note No.	₹
Share Capital:		
Shareholders' Funds	1	98,800
Share capital		

Notes to Accounts

		₹
1. Share capital		
Authorised		
.....shares of ₹ 10 each		
issued and Subscribed		....
Subscribed and fully paid up		
9,700 shares of ₹ 10 each		97,000
Subscribed and not fully paid up		
300 shares of ₹ 10 each	3000	
Less Calls in Assenes	1,200	1500
		98,800

Issue of Shares at Premium

Legal provisions A company can issue its shares at a premium (i.e., for a value higher than the face value of the shares) whether for cash of for consideration other than cash. The power to issue shares at a premium need not be given in the Articles of Association. However, according to recent guidelines issued by SEBI, a new company set up by the entrepreneurs without a track record can issue capital to the public only at par. According to Section 52 of the Companies Act, the amount of such premium, shall have to be transferred by the company to the Securities Premium Account. The balance in this account is treated with the same sanctity as the paid up Share Capital of the company.

Utilisation of Securities Premium Account

This can be studied under two heads:

(a) **Companies which are not required to follow the accounting standards [Sec. 52(2)].**

These Companies can use the Securities Premium Account for the following purposes.

(*i*) towards the issue of unissued shares of the company to members of the company as fully paid bonus shares;

(*ii*) in writing off the preliminary expenses of the company;

(*iii*) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(*iv*) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(*v*) for the purchase of its own shares or other securities under section 68.

(*b*) **Companies which are required to follow the accounting standards [Sec. 52(3)].**

These companies can use Securities Premium Account only for the following purposes:

(*i*) in paying up unissued equity shares of the company to be issued to members of the company as fully bonus shares; or

(*ii*) in writing off the expenses of, or the commission paid or discount allowed on, any issue of equity shares of the company; or

(*iii*) for the purchase of its own shares or other securities under Section 68.

Note: As stated above according to Section 52 of the Companies Act 2013 the amount of premium received on shares is to be transferred to the "Securities Premium Account". However, in the Notes to Accounts under Proforma of Balance Sheet as per Schedule III, under the heading "Reserves & Surplus", there is a sub-heading of "Securities Premium Reserve". Hence, some accountants, while making accounting entries, for share premium prefer the term "Securities Premium Reserve Account" in place of "Securities Premium Account". According to us any of the terms, i.e.,"Securities Premium Reserve Account" or "Securities Premium Account" may be used while making entries in respect of Securities premium.

However, in "Notes to Accounts" the Securities Premium will have to be shown as "Securities Premium Reserve" under the heading Reserves & Surplus as required by the Notes to Accounts given in Schedule *III*.

Accounting entries Generally the amount of premium is payable in a lump sum on allotment. However, a company may require the applicants to pay premium money with application money or with calls. The accounting entries are made as follows:

(*i*) Where premium money is payable on allotment:

On amount being due:

Shares allotment A/c *Dr.*
  To Share capital A/c
  To Securities premium A/c
(Share allotment account will be debited with the amount due on account of share capital as well as securities premium).

On receipt of allotment money:

Bank A/c *Dr.*
  To Share allotment A/c
(With the amount actually received)

NOTES

(*ii*) In case premium money is payable on application:
On receipt of application money:
Bank A/c *Dr*.
To Share application A/c
(With money received on account of share capital as well as securities premium)
On transfer of application money:
Share application A/c *Dr*.
To Share capital A/c
To Securities premium A/c

(*iii*) In case premium is received in parts, say, on application as well as allotment or allotment and first call, entries on the same pattern can be passed. For example, if premium is payable in two installments—on allotment and first call, the following accounting entries will be passed.
For premium due on allotment:
Share allotment A/c *Dr*.
To Share capital A/c
To Securities premium A/c
For receipt of allotment money:
Bank A/c *Dr*.
To Share allotment A/c
For premium due on first call:
Share 1st call A/c *Dr*.
To Share capital A/c
To Securities premium A/c
For receipt of first call money:
Bank A/c *Dr*.
To Share 1st call

Alternative Method

There is an alternative method for treatment of securities premium. No entry is passed for securities premium when it becomes due. However, on receipt of securities premium, the amount of securities premium is credited to Securities Premium Account. For example, if amount is to be received on allotment of 10,000 shares @ ₹ 3 per share (including ₹ 1 per share as premium) and only holders of 9,500 shares pay the allotment money, the following accounting entries will be passed for recording these transactions.

Date	*Particulars*		*₹ Dr*	*₹ Cr*
	Share Allotment A/c	*Dr*	20,000	
	To Share capital A/c			20,000
	Being money due on allotment on account of share) (capital			
	Bank A/c	*Dr*	29,500	
	To Share allotment A/c			20,000
	To Securities premium A/c			9,500
	Being money received on account of share allotment) (and securities premium			

The advantage of this method is that the securities premium account will not have to be debited in the event of the forfeiture of shares in case securities premium money has not been received. This has been explained in detail later while explaining forfeiture of shares.

The amount of securities premium is an item of capital gain. It will appear on the liabilities side of the balance sheet under the heading "Reserves and Surplus."

NOTES

Illustration 13.3. A company offers 10,000 shares of ₹ 10 each to the public for subscription at₹ 12 per share. Money is payable as follows:

₹ 3 on application,
₹ 4 on allotment (including ₹ 1 as premium)
₹ 5 on call (including ₹ 1 as premium)

Applications are received for 15,000 shares. No allotment is made to applicants for 3,000 shares and their application money is refunded. Rest are allotted shares on a pro rata basis. All allottees pay the money due on shares as and when called up.

Pass necessary journal entries and show how the items will appear in the company's balance sheet.

Solution:

Journal

Date	*Particulars*		*₹ Dr*	*₹ Cr*
	Bank A/c	*Dr*	45,000	
	To Share application A/c			45,000
	(Being the application money received on 15,000 shares @ ₹ 3 per share)			
	Share Application A/c	*Dr*	45,000	
	To Share capital A/c			30,000
	To Bank A/c			9,000
	To Share allotment A/c			6,000
	(Being application money transferred to share capital on 10,000 shares, application money on 3,000 shares refunded and rest transferred to allotment)			
	Share Allotment A/c	*Dr*	40,000	
	To Share capital A/c			30,000
	To Securities premium A/c			10,000
	(Being money due of allotment of 10,000 shares @₹4 per share including ₹ 1 as share premium)			
	Bank A/c	*Dr*	34,000	
	To Share allotment A/c			34,000
	(Being money received on allotment)			
	Share Call A/c	*Dr*	50,000	
	To Share capital A/c			40,000
	To Securities premium A/c			10,000
	(Being money due to call @ ₹ 5 per share including ₹ 1 as premium)			
	Bank A/c	*Dr*	50,000	
	To Share call A/c			50,000
	(Being money received on call)			

NOTES

.... CO. Ltd.
Balance Sheet
as on ....

Particulars	*Note No.*	₹
(*i*) **Equity & Liabilities**		
(a) Shareholders' Funds	1	1,00,000
(*b*) Reserves & Surplus	2	20,000
		1,20,000
(*ii*) **Assets**		
Current Assets		
Cash & Cash Equivalents	3	1,20,000
		1,20,000

Notes to Accounts

Particulars	₹
1. Share Capital	
(a) *Authorised Capital*	
...... Shares of ₹ ...... each	....
Issued Share Capital	
10,000 shares of ₹ 10 each	1,00,000
Subscribed Capital	
Subscribed but not fully paid up	
10,000 shares of ₹ 10 each fully	1,00,000
2. Reserves & Surplus	
Securities Premium Reserve	20,000
	1,20,000
3. Cash & Cash Equivalents	
Cash at Bank	1,20,000
	1,20,000

Issue of Shares at Discount

A company now cannot issue shares at a discount (*i.e.,* for a consideration less than the nominal value of the shares) except sweat equity shares. As discussed earlier, sweat equity shares are those shares which have been issued for consideration other than cash, *e.g.,* for intellectual rights or value additions. Section 53 of the Companies Act, 2013 provides as under:

(1) Except as provided in Section 54 (*i.e.,* Sweat Equity Shares), a company shall not issue shares at a discount.

(2) Any share issued by a company at discount shall be void.

(3) Where a company contravenes the provisions of this Section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

Restrictions on the issue of shares at a discount as set out above do not apply in the case of debentures since they do not form the capital fund of the company but are merely creditorship securities.

NOTES

Accounting entries The entry for discount has to be invariably made with allotment. The accounting entry will be as follows:

Share Allotment A/c *Dr.*
Discount on Issue of Shares A/c *Dr.*
To Share Capital A/c

"Discount on Issue of Shares" will appear on the Assets side of the Balance Sheet as a negative item under the heading other current/non-current assets depending on whether the amount will be amortised in next 12 month or thereafter.

It is an acceptable practice that discount on issue of shares, share issue expenses, etc., should be written off over the period of benefit, *i.e.,* normally 3 to 5 years from profits available for that purpose.

On writing off discount the following entry shall be

Securities Premium / *P & L* Statement/Account*
To Discount on Issue of Shares A/c

***Note:** Schedule III to the Companies Act 2013 gives the format in which a company has to prepare its Balance Sheet and Profit and Loss Statement. All appropriations out of profit have to be made in the Balance Sheet itself under the heading Reserves and Surplus. Hence, for reporting purposes the method given as per Schedule III has to be followed. However, accounting entries for appropriation are to be made as per the traditional procedure that is debiting the *P&L* account and crediting the Respective Appropriation Accounts. The illustration given below will explain this concept.

Illustration 13.4. A company offered 5,000 shares of ₹ 10 each, at a discount of 10%, to the public for subscription. Money was payable as follows:

₹ 4 on application, ₹ 3 on allotment, Balance as and when called up. Applications were received for 4,000 shares. The final call had not yet been made. All applicants paid application and allotment moneys.

During the year the company made a net profit of ₹ 15,000. It decided to write off the discount of ₹ 2,000 out of the profit for the year.

You are requested to prepare the necessary ledger accounts and show how the items would appear in the company's balance sheet.

Solution:

Bank Account

Particulars	₹	*Particulars*	₹
To Share application A/c	16,000	By Balance c/d	43,000
To Share allotment A/c	12,000		
To Net profit for the year (presuming that it was realised in cash)	15,000		
	43,000		43,000

NOTES

Share Application Account

Particulars	₹	*Particulars*	₹
To Share capital A/c	16,000	By Bank	16,000

Share Allotment Account

Particulars	₹	*Particulars*	₹
To Share capital A/c	12,000	By Bank A/c	12,000

Discount on Issue of Shares Account

Particulars	₹	*Particulars*	₹
To Share capital A/c	4,000	By P&L A/c	2,000
		By Balance c/d	2,000
	4,000		4,000

Profit & Loss Statement Account

Particulars	₹	*Particulars*	₹
To Discount on issue of shares A/c	2,000	By Net profit for the year	15,000
To Balance of profit taken to Balance sheet	13000		
	15,000		15,000

Share Capital Account

Particulars	₹	*Particulars*	₹
To Balance c/d	32,000	By Share application A/c	16,000
		By Share allotment A/c	12,000
		By Discount on issue of shares A/c	4,000
	32,000		32,000

Co. Ltd.
Balance Sheet
as on **...........**

Particulars	*Note No.*	₹
(*i*) **Equity & Liabilities**		
(a) Shareholder' Funds	1	32,000
(*b*) Reserves & Surplus	2	13,000
		45,000
(*ii*) **Assets**		
None-current Assets		
Other non-current Assets	3	2,000
Current Assets		43,000
Cash & Cash Equivalents	4	45,000

Notes to Accounts

Particulars	₹
1. **Share Capital**	
Authorised Capital	
..... Shares of ₹ ..... each	....
Issued Share Capital	
4,000 shares of ₹ 10 each	40,000

Subscribed Capital	
Subscribed but not fully paid up	
4,000 shares of ₹ 10 each	
₹ 8 per share called & paid up	32,000
2. **Reserves & Surplus**	
Surplus as per profit & loss statement	15,000
Less: Discount on issue of shares written off	2,000
	13,000
3. **Other Non-current Assets**	
Discount on issue of shares (yet to be written off)	2,000
4. **Cash & Cash Equivalents**	
Cash at Bank	43,000

Check Your Progress

5. What is oversubscription?
6. How does the 'discount of issue of shares' appear on the Balance Sheet?

13.7 BUYBACK OF SHARES AND TREASURY STOCK

The term buy-back refers to purchase by a company of its own shares or other specified securities. The Companies Act, 2013 makes the following provisions for buy-back of securities.

1. Power of company to purchase its own shares [Sec. 68] A company may purchase its own shares or other specified securities out of the following:

(a) Free reserves;

The term "free reserves" means such reserves which as per the latest audited balance sheet of the company are available for distribution as dividend.

(*b*) Securities premium account: or

(*c*) The proceeds of any shares or other specified securities.

However, no buy back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares and other specified securities.

A company can purchase its own shares or other specified securities subject to the following conditions:

(*i*) The buy-back should be authorised by its articles;

(*ii*) A special resolution should be passed in general meeting of the company authorising the buy-back. The buy-back should be completed within a period of one year from the date of passing of this special resolution.

Moreover, the company before making the buy-back has to file with the Registrar and the Securities Exchange Board of India a declaration of solvency in the prescribed form signed by at least two directors of the company one of whom shall be the Managing Director.

(*iii*) The buy-back should not exceed 25 per cent of the total paid capital and free reserves of the company. Provided that the buy-back of equity shares in any financial year shall not exceed twenty five per cent of its total paid-up equity capital in that financial year.

(*iv*) The ratio of the debt owed by the company should not be more than twice the capital and its free reserves after such buy-back. However, the Central Government may prescribe a higher ratio of the debt than the specified above for a class or classes of companies. The expression "debt" for this purpose includes all amounts of secured and unsecured debts, long as well as short-term.

(*v*) All the shares or other specified securities for buy-back are fully paid-up.

(*vi*) The buy-back of the shares or other specified securities listed on any recognised stock exchange should be in accordance with the regulations made by the Securities and Exchange Board of India in this behalf. In any other case, the buy-back should be in accordance with the guidelines prescribed.

(*vii*) The buy-back may be made:

- From the existing shareholders or security holders on a proportionate basis;
- From the open market;
- From the odd lots;
- By purchasing the securities issued to the employees of the company pursuant to a scheme of stock option or reveal equity.

(*viii*) Where a company buys back its own securities, it shall extinguish and physically destroy the securities so bought back within seven days of the last date of completion of buy-back.

(*ix*) Where a company completes the buy-back of its shares or other specified securities as above, it shall not make further issue of the same kind of shares or other speficied securities within a period of 6 months except in the following form—

(*a*) Bonus issue;

(*b*) Discharge of subsisting obligations such as conversion of warrants;

(*c*) Stock option schemes;

(*d*) Sweat equity shares or conversion of preference shares or debentures into equity shares.

A company has to maintain a separate register of the securities so bought back with all relevant details.

(*x*) The company shall file a return containing details of buy-back with the Registrar and *SEBI* within 30 days of completion of buy back. However, no return has to be filed with *SEBI* if the shares are not listed on a recognised stock exchange.

NOTES

In case of listed companies, *SEBI*: has made the following additional provisions as per *SEBI* (Buy-back of Securities). Regulations

(*a*) The buy-back may be from the open market through
  (*i*) book-building process
  (*ii*) stock exchange

(*b*) A company listed on a stock exchange shall not buy-back its shares of other specified securities so as to delist its shares or other specified securities from the stock exchange.

(*c*) A company shall not make any offer of buy-back within a period of one year reckoned from the date of closure of the preceding offer of buy-back, if any.

(*d*) A copy of the special resolution passed at the general meeting for buy-back or securities shall be filed with the *SEBI* and the stock exchanges where the shares or other specified securities of the company are listed, within seven days from the date of passing of the resolution.

2. Transfer of Capital Redemption Reserve Account (69) In case a company purchases its own shares out of free reserves or securities premium account, a sum equal to nominal value of the shares so purchased shall be transferred to capital redemption reserve account.

3. Prohibition for buy-back (70) No company shall directly or indirectly purchase its own shares or other specified securities—

(*a*) Through any subsidiary company including its own subsidiary companies;

(*b*) Through any investment company or group of investment companies;

(*c*) If a default is subsisting by the company in respect of any of the following;

- any deposit or interest due thereon;
- redemption of debentures or preference shares;
- payment of dividend to any shareholder;
- repayment of any term loan or interest thereon to any financial institution or banking company.

Moreover, the company should not have defaulted in filing (presumably in the year in which buy-back operations are carried out) its annual return (Section 92), payment of dividend (Sections 123 & 124) and preparation of balance sheet and profit and loss account to reveal the true and fair view in accordance with the Schedule III to the Companies Act. (Section 129).

NOTES

Accounting Treatment: The accounting entries in case of buy-back of shares are as follows:

(*i*) ***For issue of new shares for buy-back purposes:***

Bank Account	*Dr.*
Discount on issue of shares Account*	*Dr.*
To Share capital	
To Securities premium Account*	
(Only one figure will appear)	

(*ii*) ***On payment of amount for buy-back***

Share capital A/c	*Dr.*
(nominal value of shares bought back)	
Free reserves/Securities premium share/general reserve etc A/c	*Dr.*
(with the extra amount paid)	
To Bank A/c	

(*iii*) ***For transfer to Capital Redemption Reserve***

Free reserves/general reserve/securities premium etc. A/c	*Dr.*
(with nominal value of shares bought back out of free reserves)	
To Capital redemption/buy-back reserve A/c	

Capital Redemption or Buy-back Reserve may be applied by the company in paying up the unissued shares of the company to be issued to members of the company as fully paid bonus shares.

(*iv*) ***Expenses on buy-back***

Buy-back expenses A/c	*Dr.*
To Bank	
(with the actual amount of expenses paid)	

The buy-back expenses may be set off against the current profit and loss account or from reserves in the year of buy-back.

Illustration 13.5. The following is the Balance Sheet of *XYZ* Ltd. as on 31 March 2017:

Particulars		₹
A. Equity and Liabilities		
1. Shareholders' funds		
(a) Share capital		
Equity share capital (₹ 10 per share)	50,000	
Preference Share Capital (₹ 10 per Share)	5,000	55,000
(*b*) Reserves & Surplus		
Securities Premium Reserve	5,000	

Particulars			₹
General Reserve		55,000	
Surplus from Profit & Loss Statement	10,000		
Less: Miscellaneous Exp. Written off	10,000	....	
Investment allowance			
(available for utilization ₹ 10,000)		18,000	
Capital redemption reserve		2,000	
Debenture redemption reserve		20,000	1,00,000
2. Non-current liabilities			
10% Debentures		40,000	
Term loan (Secured)		15,000	
Unsecured loan		25,000	80,000
3. Current liabilities & provisions			1,05,000
			3,40,000
B. Assets			
1. Non-Current assets			
(a) Tangible assets			
Fixed assets (Net)		1,50,000	
Intangible		10,000	
(*b*) non-current investments		60,000	2,20,000
2. Current assets			
Loans & advances			1,20,000
			3,40,000

The following additional information has been furnished to you:

(*i*) Investments of the cost of ₹ 20,000 were sold for ₹ 15,000.

(*ii*) The income tax authorities imposed an additional tax liability of ₹ 1,000 for the year 2016.

(*iii*) The company intends to buy back its equity shares in the beginning of the next financial year to the maximum extent as permissible under law.

You are required:

(a) to compute the maximum amount of equity shares that can be purchased by the company

(*b*) pass necessary journal entries assuming that such buy back has been carried out and make out the new Balance Sheet.

Workings should form part of your answer.

Solution: Basic Workings:

1. Computation of maximum number of Equity Shares & Price per share for Buy Back:

(*i*) *Free Reserve for Buy-back:*

	₹	₹
Securities premium	5,000	
General reserve	55,000	
Investment allowance reserve (available)	10,000	70,000

NOTES

	Less: Tax liability for 2016	1,000	
	Loss on sale of investments	5,000	
	Good will	10,000	
			16,000
			54,000
(*ii*)	Equity share capital		50,000
	Preference share capital		5,000
			55,000
(*iii*)	Share capital & free reserves (*i*) + (*ii*)		1,09,000
(*iv*)	25% of share capital & free reserves (1/4 × 1,09,000)		27,250
(*v*)	25% of the equity share capital		12,500
	Hence maximum no. of equity shares that can be purchased		
	In a financial year		1,250
(*vi*)	Maximum amount available for buy-back		27,250
(*vii*)	Maximum price that can be paid for buy back of a share (27,250/1,250)		21.80
(*viii*)	Maximum premium payable per equity share (₹ 21.80 – ₹ 10)	11.80	
(*ix*)	Total premium payable on buy back (1,250 × 1.80)		14,750
(*x*)	Amount payable as face value of equity share (1,250 ×10)	12,500	

Check Your Progress

7. Define free reserves.
8. What is the maximum buy-back amount for a company in relation to its paid up capital and free reserves?

13.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The meaning of perpetual existence in relation to companies means that the mode of incorporation and dissolution of a company and the right of the members to transfer shares freely, guarantees the continuity of the existence of the company quite independent of the life of the members.
2. An inactive company means a company which has not been carrying on any business or operation or has not made any significant accounting transactions during the last 2 financial years, or has not filed financial statements and annual returns during the last 2 financial years.
3. A stock refers to the aggregate consolidated holdings of the share capital of a person.
4. The two types of equity shares are: (i) with voting rights; and (ii) with differential rights as to dividends, voting or otherwise in accordance with the rules and subject to such conditions as may be prescribed.
5. A company, making a public offer, may receive applications for a larger number of shares than offered by it to public for subscription. Such a situation is termed as oversubscription.

6. The ‘Discount of Issue of Shares’ appear on the Assets side of the Balance Sheet as a negative item under the heading other current/non-current assets depending on whether the amount will be amortised in the next 12 month or thereafter.
7. The term ‘free reserves’ means such reserves which are as per the latest audited balance sheet of the company are available for distribution as dividend.
8. The buy-back should not exceed 25 per cent of the total paid capital and free reserves of the company. Provided that the buy-back of equity shares in any financial year shall not exceed twenty five per cent of its total paid-up equity capital in that financial year.

13.9 SUMMARY

- Joint Stock Companies represent the third stage in the evolution of forms of business organisation. Unlike sole proprietorship and partnership firms, a company enjoys a separate legal status. The ownership is here divorced from the management. The shareholders contribute towards the finances of the company but all of them do not and cannot participate in the management of the company. The company is managed by a Board of Directors elected by shareholders.
- In common parlance, company means, an association of persons formed for the economic gain of its members. However, in law, any association of persons for any common object can be registered as a company. The object need not be the economic gain of its members, e.g., a company can be formed for purposes such as charity, research, advancement of knowledge, etc.
- The essential characteristics of a company include: voluntary association, perpetual existence, common seal, limited liability, and transferability of shares, etc.
- The kinds of companies are statutory companies, registered companies, holding companies, government company, foreign company, one-man companies, small company, dormant company, associate company, global company, multinational company, and charitable or non-profit making companies.
- A company may be formed either to take over an existing business or to carry on a new business. Whatever may be the objective, the procedure for the formation of a company, from the time the idea of forming a company is first conceived till the company is actually formed and commences business, may be divided into three principal stages: (i) Promotion, (ii) Incorporation and (iii) Commencement of business.
- The stage of conceiving an idea and its working up is termed as promotion. The person involved in this task is termed as promoter. The

promoter may work up the idea with the help of his own resources, influence or competence or he may, if necessary, take the help of technical experts to find out the economics of the project he has in his mind.

- It is the incorporation which brings a company into existence as a separate corporate entity. The promoter has to take the following preliminary steps in this connection: ascertainment of availability of proposed name, application for licence, SEBI's approval to Draft prospectus. Prepare and get printed the memorandum, and article of association and fixation of underwriters, brokers, solicitors, auditors, etc.
- A share is one of the units into which the total share capital of a company is divided. The Companies Act, 2013 defines a share as "share in the share capital of a company and includes stock". [Sec. 2(84)].
- Fully paid up share capital may, if the Articles so permit, be converted into stock by an ordinary resolution (a resolution by simple majority) of the members. Stock is the aggregate consolidated holdings of the share capital of a person. It can be divided and transferred in any fractions and sub-divisions without regard to the original face value of the share for the purpose of convenient holding into different parts.
- There are different types of shares: preference and equity. Further preference shares are divided on the basis of dividend, participation redeemability and convertibility.
- A company may not receive applications for all the shares offered by it to the public. For example, it might have offered 8,000 shares to the public but applications might have been received only for 6,000 shares. Such a situation is called under subscription.
- A company, making a public offer, may receive applications for a larger number of shares than offered by it to public for subscription. Such a situation is termed as oversubscription.
- A company can issue its shares at a premium (i.e., for a value higher than the face value of the shares) whether for cash of for consideration other than cash. The power to issue shares at a premium need not be given in the Articles of Association. However, according to recent guidelines issued by SEBI, a new company set up by the entrepreneurs without a track record can issue capital to the public only at par.
- A company now cannot issue shares at a discount (i.e., for a consideration less than the nominal value of the shares) except sweat equity shares. As discussed earlier, sweat equity shares are those shares which have been issued for consideration other than cash, e.g., for intellectual rights or value additions.

- The term buy-back refers to purchase by a company of its own shares or other specified securities. The term “free reserves” means such reserves which as per the latest audited balance sheet of the company are available for distribution as dividend.

13.10 KEY WORDS

- **Allotment:** It is the appropriation out of previously unappropriated share capital of the company.
- **Articles of Association:** A document containing rules and regulations and bye-laws for governing the internal affairs of a company being framed in pursuance of the Companies Act.
- **Associate Company:** In relation to another company, it means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.
- **Company:** An association of persons formed and registered under the Companies Act.
- **Government Company:** A company of which not less than 51% of the paid up share capital is held by the Central Government or by the State Government or by any two or more of them together.
- **Holding & Subsidiary Companies:** A company which controls another company is known as holding company and the company so controlled is termed as subsidiary company.
- **Incorporation:** The process of getting a company registered under the Companies Act.
- **Memorandum of Association:** A document confining and defining the scope of activities of the company and framed in pursuance of the Companies Act.
- **One Person Company:** A company which has only one person as a number.
- **Private Company:** A company which by its Articles:
  (*i*) restricts the right of its members to transfer shares;
  (*ii*) except in case of one person company limits the number of members to two hundred; and
  (*iii*) prohibits any invitation to the public to subscribe for its shares or debentures.
- **Prospectus:** Any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or offers from the public for the subscription or purchase of any securities of a body corporate.

NOTES

- **Promotion:** The stage of conceiving an idea and its working up.
- **Promoter:** A person who conceives the idea of starting a business, plans the formation of a company and actually brings it into existence.
- **Public Company:** A company which is not a private company

13.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Define a company and state its essential characteristics.
2. What is a 'share'? Discuss their different classes.
3. State the purposes for which the money received on account of share premium can be used.
4. Write short note on Redemption of Preference Shares
5. Can share premium be distributed as dividends?
6. What is meant by sweat equity share?

Long Answer Questions

1. What is allotted of shares? Explain the statutory restrictions imposed on allotment of shares.
2. Explain the documents that have to be filled with the Registrar of Companies for getting a company incorporated.
3. State the conditions which are required to be satisfied by a company for the purpose of buy-back of shares
4. Explain the conditions under which redeemable preference shares can be redeemed.

Practical Problems

1. Following is the balance sheet of Danny Ltd. as on 31st March, 2015:

Balance Sheet

Particulars	₹ (*000*)
A. Equity and Liabilities	
1. Shareholders' Funds	
(i) Share Capital 3,00,000 shares of ₹ 10 each	3,000
(ii) Reserves & Surplus:	
(a) General Reserve	100
(b) Securities Premium reserve	5
2. Non-current Liabilities:	
Long-term Borrowings	
10% Debentures	1,400
3. Current Liabilities:	
Accounts Payable	1,560
	6,065

Particulars	₹ (000)
B. Assets	
1. Non-current Assets:	
Land & Building	630
Plant & Machinery	2,350
Furniture & Fittings	350
2. Current Assets:	
Current Investments	370
Inventories	1,200
Accounts Receivable	590
Cash & Bank Balance	575
	6,065

NOTES

On 1st April, 2015, the shareholders of the company have approved the scheme of buy-back of equity shares as under:

(*i*) 15% of the equity shares would be bought-back at ₹ 11 per share.

(*ii*) Balance in the general reserve and securities premium account may be utilised to the fullest extent for this purpose.

(*iii*) Issue 12% redeemable preference shares of ₹ 10 each as per the requirements.

Pass the journal entries to record the above transactions and prepare the balance sheet of the company immediately after the buy-back of shares. (*ICSI, June, 2006, adapted*)

[**Ans.** *CRR* Balance ₹ 60,000; B/s Total ₹ 59,60,000]

2. Following is the Balance Sheet of M/s Competent Limited as on 31st March, 2015:

Assets	₹	*Assets*	₹
Equity Shares of ₹ 10 each fully paid	12,50,000	Fixed Assets	46,50,000
Revenue Reserve	15,00,000	Current Assets	30,00,000
Securities Premium	2,50,000		
Profit & Loss Account	1,25,000		
Secured Loans:			
12% Debentures	18,75,000		
Unsecured Loans	10,00,000		
Current Liabilities	16,50,000		
Total	76,50,000	Total	76,50,000

The company wants to buy back 25,000 equity shares of ₹ 10 each, on 1st April. 2015 at ₹ 20 per share. Buy back of shares is duly authorized by its articles and necessary resolution passed by the company towards this. The payment for buy back of shares will be made by the company out of sufficient bank balance available as part of Current Assets.

Comment with your calculations, whether buy back of shares by company is within the provisions of the companies Act, 2013. If yes, pass necessary journal entries towards buy back of shares and prepare e-Balance Sheet after buy back of shares. (*IPCE, ICAI, May 2012, adapted*)

[**Ans.** Maximum buy back of shares 31,250]

NOTES

13.12 FURTHER READINGS

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

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

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

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

UNIT 14 COMPANY ACCOUNTS-II

NOTES

Structure

14.0 Introduction
14.1 Objectives
14.2 Forfeiture of Shares
14.3 Redemption of Preference Shares
14.4 Right Issue
14.5 Debentures
14.6 Answers to Check Your Progress Questions
14.7 Summary
14.8 Key Words
14.9 Self Assessment Questions and Exercises
14.10 Further Readings

14.0 INTRODUCTION

Uptill now, we have learned the company accounts in the context of meaning of different companies, and formation of companies. We also learned about the companies' financial backing through the concept of share capital, particularly the undersubscription, oversubscription as well as buy back of shares. In this unit, we will turn our focus towards certain other kinds of securities and their treatment in the company accounts.

Forfeiture of shares happen under situations when the owners of the shares are unable to meet the purchase requirements of the company. Redemption of preference shares is the condition that the preference shareholder will be repaid the amount they have invested in the company on a future date provided they company the set conditions. Rights issue are shares offered to the existing shareholders at a discount for the purpose of raising funds. The company's requirement to raise funds is met by the company partly by raising share capital and partly by depending on public borrowings. One form of such public borrowings is to raise money by issue of debentures.

In this unit, we will learn about the provisions related to and the accounting entries related to the forfeiture of shares, redemption of preference shares, right issue and debentures.

14.1 OBJECTIVES

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

- Discuss the concept of forfeiture of shares
- Describe the redemption of preference shares
- Explain the concept of right issue in company accounts
- Examine the treatment of debentures in company accounts

14.2 FORFEITURE OF SHARES

NOTES

Legal provisions Forfeiture of shares may be defined as termination of membership and taking away of the shares because of default in payment of allotment and/or call money by a shareholder. The Companies Act does not contain any specific provision regarding forfeiture of shares. However, Regulation, 28 to 34 of Model Articles of a company limited by shares (as contained in Table *F* of Schedule I of the Companies Act, 2013) make provision forfeiture of shares.

These provisions can be summarized as under.

(*i*) The power to forfeit shares must be expressly given by the company's Articles.

(*ii*) The procedure given in the Articles must be followed.

(*iii*) There should be a default by the shareholder in payment of a valid call.

(*iv*) A notice of demand, requiring the shareholder to pay calls of a specified amount within 14 days must be given.

(*v*) The Board of Directors must pass a resolution for forfeiture of shares.

(*vi*) The power to forfeiture must be exercised in good faith and in the interest of the company.

(*vii*) Forfeited shares may be sold or otherwise disposed of by the Board, as it deems fit. Board can cancel forfeiture on such terms as it deems fit.

The shareholder, whose shares have been forfeited, shall cease to be the member of the company. If the articles of the company permit, the company can sue him for unpaid calls even after the forfeiture. In such a case the ex-shareholder will be liable as an ordinary debtor and not as a contributory. But where the company goes into liquidation within one year of the forfeiture of shares, the ex-shareholder can be put on "List *B* contributories."[1]

Accounting entries The following points should be taken into account while passing an accounting entry for forfeiture of shares.

(*i*) The amount called up on the shares forfeited.

(*ii*) The amount unpaid on various calls (including allotment) on the shares forfeited.

(*iii*) The amount received on the shares forfeited.

Forfeiture of shares results in reduction of share capital and therefore the share capital account should be debited with the amount called up on these

[1] A "List B Contributory" can be required to pay the unpaid calls in the event of a company's winding up if the existing shareholder is not in a position to pay such calls.

shares so far. The various unpaid calls account should now be cancelled and therefore they should be credited and the balance representing the amount received on the shares forfeited should be credited to a new account termed as "Forfeited Shares Account."

Share capital A/c *Dr.*
To Unpaid call(s) A/c
To Forfeited shares A/c
(Being forfeiture of…shares as per Board's resolution no…dated…..)

Shares, as explained before, can be issued at par, at premium or at discount. The accounting entries for forfeiture of shares in each of these cases are being explained below:

Forfeiture of shares issued at par The journal entry will be as follows:

Share capital A/c (with the amount called up) Dr.
To Unpaid call(s) A/c (with the amount, remaining unpaid)
To Forfeited shares A/c (with the amount received)

Illustration 14.1. A company forfeits 100 shares of ₹ 10 each fully called up on which the shareholder has failed to pay the allotment money of ₹ 2 per share and call money of ₹ 3 per share.

Solution:

The Journal entry for forfeiture will be as follows:

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Share Capital A/c	*Dr.*	1,000	
	To Share allotment A/c			200
	To Share call A/c			300
	To Shares forfeited A/c			500

Forfeiture of shares issued at premium There can be two situations.

(*i*) The amount of share premium had not been received but it was credited to "Securities Premium Account", when the amount became due. The journal entry for forfeiture will be:

Share capital A/c (with the amount called up) Dr.
Securities premium A/c (with the amount of premium called) Dr.
To Unpaid calls A/c
To Forfeited shares A/c

Illustration 14.2. A company forfeits 100 shares of ₹ 10 each issued at ₹ 11 per share. The premium was payable on allotment. The shareholder failed to pay allotment money of ₹ 3 per share (including premium) and the call money of ₹ 2 per share.

Solution:

The journal entry for forfeiture will be as follows:

NOTES

Date	Particulars		₹	₹
	Share capital A/c	*Dr.*	1,000	
	Securities premium A/c	*Dr.*	100	
	To Share allotment A/c			300
	To Share call A/c			200
	To Forfeited shares A/c			600

(*ii*) The amount of share premium has either been received or even if not received, the company has given credit to the securities premium account only with the amount of premium received.

The journal entry will be:

Share capital A/c Dr.

(with the amount called up on account of share capital)

To Unpaid calls

(with unpaid amount excluding share premium)

To Forfeited shares A/c

(with the amount received)

Share premium once received cannot be cancelled. This is because of Section 52 which provides for the use of share premium received, only for certain specified purposes, as explained before.

Illustration 14.3. A company forfeits the shares held by two shareholders—*A* and *B*.

(*i*) *A* holds 100 shares of ₹ 10 each on which he has paid ₹ 5 per share (₹ 3 on application and ₹ 2 on allotment including ₹ 1 as premium payable on allotment) as application and allotment moneys but has failed to pay the call of ₹ 6 per share.

(*ii*) *B* holds 200 shares of ₹ 10 each on which he has paid ₹ 3 per share, as application money. He has failed to pay the allotment and call money.

The company gives credit to securities premium account only when it is received.

Pass necessary journal entries.

Solution:

S.No	Particulars		Dr. ₹	Cr. ₹
(*i*)	Share Capital A/c	*Dr.*	1,000	
	To Share call A/c			600
	To Shares forfeited A/c			400
	(Being forfeiture of 100 shares held by *A*)			
(*ii*)	Share Capital A/c	*Dr.*	2,000	
	To Share allotment A/c			200
	To Share call A/c			1,200
	To Shares forfeited A/c			600
	(Being forfeiture of 200 shares held by *B*)			

Forfeiture of shares issued at discount In such a case the discount allowed on issue of shares will have to be cancelled. The journal entry will be:

Share Capital A/c Dr.
To Unpaid call A/c
To Forfeited shares A/c
To Discount on issue of shares A/c

Illustration 14.4. A company forfeits 100 shares of ₹ 10 each issued at ₹ 9 per share on account of non-payment of final call of ₹ 4 per share by the shareholder.

Solution:

The journal entry for forfeiture will be as follows:

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Share capital A/c *Dr.*	1,000	
	To Share final call A/c		400
	To Forfeited Shares A/c		500
	To Discount on issue of shares A/c		100

Reissue of Forfeited Shares

Forfeited shares become the property of the company and the company can always reissue them at its convenience. They can be reissued at par, premium or discount. However, in case they are reissued at discount, the amount of discount cannot exceed the amount that had been received on these shares. In other words there cannot be any loss on account of reissue of forfeited shares.

Accounting entries While passing accounting entries regarding reissue of forfeited shares the following points should be taken into account.

(*i*) The amount at which they are taken as paid up on reissue.

(*ii*) The amount that had already been received on the shares forfeited.

(*iii*) The amount allowed as discount.

The journal entry will be:

Bank A/c (with the amount recd.) Dr.
Forfeited Shares A/c (with the discount allowed) Dr.
To Share Capital A/c (with the amount taken as paid up)

Illustration 14.5. A company forfeits 100 shares of ₹ 10 each on which ₹ 300 had been received. The company can allow a maximum discount of ₹ 300 on these shares. In case these shares are reissued for ₹ 900 fully paid, pass the necessary journal entries.

NOTES

Solution:

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	900	
	Forfeited Shares A/c	Dr.	100	
	To Share capital A/c			1,000
	(Being reissue of 100 forfeited shares)			

The balance standing to the credit of "forfeited shares account", is a capital profit and therefore, it will be transferred to capital reserve. The journal entry will be:

Date	Particulars		Dr. ₹	Cr. ₹
	Forfeited Shares A/c	Dr.	200	
	To Capital reserve			200
	(Being profit on reissue of forfeited shares transferred to capital reserve)			

In case only a part of the forfeited shares have been reissued, only the proportionate profit on reissue of forfeited shares will be transferred to capital reserve.

For example, if in the above case only 60 shares are reissued at ₹ 9 per share, the amount to be transferred to Capital Reserve will be ₹ 120

$$\left(i.e.\text{₹ } 300 \times \frac{60}{100} - \text{₹ } 60\right)$$

Reissue of forfeited shares originally issued at discount In case the forfeited shares were originally issued at discount, the maximum permissible reissue discount, is the sum received on forfeited shares and original discount.

For example, if a share of ₹ 10 was originally issued at a discount of ₹ 1 is forfeited, and the amount received on it was ₹ 2, the maximum discount on reissue of such a forfeited share can be ₹ 3 (*i.e.,* original discount ₹ 1 + amt. recd. ₹ 2). The Journal entry will be as follows in case the share is reissued for ₹ 7 per share, fully paid up.

	Particulars		₹	₹
	Bank A/c	Dr.	7	
	Discount on issue of shares A/c	Dr.	1	
	Forfeited shares A/c	Dr.	2	
	To Share capital A/c			10

Illustration 14.6. *B* Ltd. forfeited 100 shares of ₹ 10 each, ₹ 8 per share being called up, which were issued at a discount of ₹ 1 per share for non-payment of first call of ₹ 3 per share. Of these forfeited shares, 80 shares were reissued subsequently by the company at ₹ 5, as ₹ 8 paid up per share. Give journal entries for the forfeiture and reissue of shares.

Solution:

NOTES

In the Books of *B* Ltd.
Journal Entries

Date	Particulars		Dr. ₹	Cr. ₹
	Share Capital A/c (100 × ₹ 8)	Dr.	800	
	To Shares forfeited A/c (100 × ₹ 4)			400
	To Discount on issue of shares A/c (100 × ₹ 1)			100
	To Shares first call A/c (100 × ₹ 3)			300
	(Being forfeiture of 160 shares of ₹ 10 each, ₹ 8 called up issued at a discount of ₹ 1 per share for non-payment of first call of ₹ 3 per share)			
	Bank A/c (80 × ₹ 5)	Dr.	400	
	Discount on issue of shares A/c (80 × ₹ 1)	Dr.	80	
	Shares Forfeited A/c (80 × ₹ 2)	Dr.	160	
	To Share Capital A/c (80 × ₹ 8)			640
	(Being reissue of 80 forfeited shares of ₹ 10 each, ₹ 8 called up, originally issued at a discount of ₹ 1 per share, for ₹ 5 per share, credited as ₹ 8 per share)			
	Shares Forfeited A/c	Dr.	160	
	To Capital Reserve A/c			160
	(Being transfer of capital profit proportionate to forfeited shares reissued, *i.e.*, on 80 shares, to capital reserve account)			

Reissue of forfeited shares originally issued at premium It is not necessary that if the shares were originally issued at premium, their reissue after forfeiture should also be at premium or that the premium should be at the same rate. However, if any premium is received (i.e., over and above the amount taken as paid up on account of share capital), the amount should be credited to the "securities premium account."

Illustration 14.7. A company forfeits 100 shares of ₹ 10 each, originally issued at a premium of ₹ 2 per share. The shareholder paid ₹ 4 per share on application but did not pay the allotment money of ₹ 4 per share (including premium) and call of ₹ 4 per share. The company takes credit for the premium as soon as it becomes due. The shares are subsequently reissued at ₹ 11 per share fully paid up.

Pass journal entries for forfeiture and reissue of forfeited shares.

Solution:

NOTES

Journal

Date	Particulars		₹	₹
	Share Capital A/c	*Dr.*	1,000	
	Securities Premium A/c	*Dr.*	200	
	To Share Allotment A/c			400
	To Share Call A/c			400
	To Shares Forfeited A/c			400
	(Being forfeiture of 100 shares on account of non-payment of allotment and call moneys)			
	Bank A/c	*Dr.*	1,100	
	To Share Capital A/c			1,000
	To Securities Premium A/c			100
	(Being reissue of forfeited shares)			
	Shares Forfeited A/c	*Dr.*	400	
	To Capital Reserve			400
	(Being transfer of profit on shares forfeited to capital reserve)			

Alternative approach Some accountants are of the opinion that securities premium account appearing in the Balance Sheet should have definite relevance with the number of shares actually issued. Hence, in case shares are subsequently issued at a premium at a rate lower than the rate at which they were originally issued and the premium amount had not been received at the time of original issue, the shortfall should be met out of the shares forfeited account. For example, on the basis of the figures given in the previous illustration, the journal entry will be as follows:

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	*Dr.*	1,100	
	Shares Forfeited A/c	*Dr.*	100	
	To Share Capital A/c			1,000
	To Securities premium A/c			200
	(Being reissue of 100 forfeited shares)			

However, such an approach may create problems in cases where forfeited shares account does not have sufficient amount to meet the shortfall on account of share premium. Thus, it is better to follow the first method given before.

Illustration 14.8. *A* holds 100 shares of ₹ 10 each on which he has paid ₹ 1 per share as application money.

B holds 200 shares of ₹ 10 each on which he has paid ₹ 1 on application and ₹ 2 on allotment.

C holds 300 shares of ₹ 10 each and has paid ₹ 1 on application, ₹ 2 on allotment and ₹ 3 for the first call.

They all fail to pay their arrears and the second call of ₹ 2 per share and the Directors, therefore, forfeited their shares. The shares of *C* were then reissued at ₹ 7 per share as fully paid-up.

Give the necessary journal entries to record the above transactions.

Solution:

The amount called up has been calculated as follows:

On Application	₹ 1
On Allotment	₹ 2
On First Call	₹ 3
On Second Call	₹ 2
Total Called up	₹ 8

Journal

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Share Capital A/c	*Dr.*	4,800	
	To Share Allotment A/c			200
	To Share First call A/c			900
	To Share Second Call A/c			1,200
	To Forfeited Shares A/c			2,500
	(Being forfeiture of 600 shares)			
	Bank A/c	*Dr.*	2,100	
	Forfeited Shares A/c	*Dr.*	900	
	To Share Capital A/c			3,000
	(Being 300 shares reissued at ₹ 7 each fully paid up)			
	Forfeited Shares A/c	*Dr.*	900	
	To Capital Reserve A/c			900
	(Being surplus on forfeiture and reissue of 300 shares transferred to capital reserve)			

Working Notes:

(*i*) Amount not paid:

	Allotment	*First Call*	*Second Call*
A	200	300	200
B	–	600	400
C	–	–	600
	200	900	1,200

(*ii*) The amount transferred to Capital Reserve has been calculated as follows:

Amount received on *C*'s shares (300 × 6)	₹ 1,800
Less: Discount allowed on reissue (300 × 3)	₹ 900
Net Gain	₹ 900

Check Your Progress

1. State the condition in which the ex-shareholder can be put on 'List B contributories'?
2. What is the condition for reissue of forfeited shares at discount?

NOTES

14.3 REDEMPTION OF PREFERENCE SHARES

A company cannot return its share capital to its shareholders during its lifetime except as provided under provisions The Companies Act (e.g. buy-back of shares). However, a company can issue a special category of shares termed as Redeemable Preference Shares, which the company can redeem during its lifetime as per the provisions of Section 55 of the Companies Act, 2013. These provisions have been framed keeping in view the fact that the interest of the third parties are not adversely affected on account of return of share capital to the shareholders.

The legal provisions are as follows:

(*i*) The issue of redeemable preference shares must be authorised by the Articles of Association Shares already issued cannot be converted into redeemable preference shares.

(*ii*) A company can issue preference shares which are liable to be redeemed within a period not exceeding twenty years from the date of their issue subject to such conditions as may be prescribed: Provided that a company may issue preference shares for a period exceeding twenty years for infrastructure projects, subject to the redemption of such percentage of shares as may be prescribed on an annual basis at the option of such preferential shareholders.

(*iii*) Such shares cannot be redeemed unless they are fully paid.

(*iv*) These shares can be redeemed subject to the terms and manners laid down in the Articles and only (a) out of the profits of the company which would otherwise be available for dividend or (*b*) out of the proceeds of a fresh issue of shares made for the purpose of redemption.

It is to be noted that amount in the securities premium account or development rebate reserve account or capital reserve etc., is not available for distribution by way of dividend, and, therefore, such funds cannot be used for redemption of preference shares. Similarly, the term "proceeds of fresh issue' does not include the amount received by way of securities premium since Section 52 does not permit use of securities premium for the redemption of preference share capital. However, if the shares are issued at a discount, the net amount received should be taken into consideration for calculating the "proceeds of the fresh issue."

(*v*) Where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, the company must out of the profits which would have been otherwise available for dividend, transfer to 'Capital Redemption Reserve Account' a sum equivalent to the nominal amount of shares redeemed. 'Capital Redemption Reserve Account' may subsequently be utilised for the purpose of issuing fully paid bonus shares to the members of the company.

In the case of a capital reduction scheme, the capital redemption reserve account can be reduced in the same way as paid up share capital of the company.

The effect of the provisions given in clauses (*iv*) and (*v*) above is the replacement of redeemable preference share capital by fresh share capital or by Capital Redemption Reserve Account. Capital Redemption Reserve Account can be used only for issuing fully paid bonus shares. The intention of the law, therefore, is to keep intact even redeemable preference share capital by replacing such share capital by share capital issued for cash or issued out of profits as bonus shares.

(*vi*) Where any shares are redeemed out of the proceeds of the fresh issue, the premium, if any, payable on redemption must be provided for out of the profits of the company or out of the balance in the Securities Premium Account.

(*vii*) Where a company is not in a position to redeem any preference shares or to pay dividend, if any, on such shares in accordance with the terms of issue (such shares hereinafter referred to as unredeemed preference shares), it may, with the consent of the holders of three-fourths in value of such preference shares and with the approval of the Company Law Tribunal on a petition made by it in this behalf, issue further redeemable preference shares equal to the amount due, including the dividend thereon, in respect of the unredeemed preference shares. On the issue of such further redeemable preference shares, the unredeemed preference shares shall be deemed to have been redeemed.

(*viii*) Company must notify the fact of the redemption of shares to the Registrar of Joint Stock Companies within one month of such redemption.

Accounting entries The following are the accounting entries to be passed in the books of a company which wants to redeem its redeemable preference share capital.

(*i*) ***For making partly paid up shares fully paid up:***

(a) Redeemable preference share final call A/c *Dr.*

To Redeemable preference share capital A/c

(For final call being made)

(*b*) Bank A/c *Dr.*

To Redeemable preference share final call A/c

(For money realised on final call)

(*ii*) ***For redeeming out of profits:***

Profit & Loss A/c/Revenue reserves A/c *Dr.*

To Capital redemption reserve A/c

(*iii*) ***For a fresh issue of shares:***

Bank A/c *Dr.*

To Share capital A/c

(In case of issue of shares at premium or discount, the relevant account should be credited or debited)

(*iv*) ***Making provision for payment of premium on redemption of preference shares:***

Securities premium/Profit and Loss/Revenue or Capital reserve A/c *Dr.*

To Premium on redemption of preference share A/c

(*v*) ***For money due to redeemable preference shareholders:***

Redeemable preference share capital A/c *Dr.*

Premium on redemption of preference shares A/c *Dr.*

To Redeemable preference shareholders/preference shares redemption A/c

(*vi*) ***For payment of redeemable preference shareholders:***

Redemable preference shareholders/preference share redeemable A/c

To Bank A/c

(*vii*) ***For issue of bonus shares:***

(a) redemption reserve/Share premium/Revenue reserve A/c *Dr.*

To Bonus payable A/c

(*b*) Bonus payable A/c *Dr.*

To Share capital A/c

Tutorial Notes: The following points are worth noting:

(*i*) **Calls in Arrears.** In case calls are in arrear in respect of certain redeemable preference shares, such preference shares can be redeemed only when the calls are paid by the shareholders concerned. While attempting an examination problem, the students should not redeem these preference shares till the calls are paid. The amount of such preference capital not redeemed because of unpaid calls may be allowed to remain as Redeemable Preference Share Capital. Alternatively the amount of such capital may be transferred to Redeemable Preference Share Capital Suspense Account till a final decision (whether to forfeit or not) is taken. the Red. Pref. Share Capital Suspense Account may be shown under the heading Share Capital in the balance sheet. However, if a fresh issue is to be made for redemption of the preference shares, such issue should be made presuming that the shareholders holding preference shares against which calls are in arrears will also make payment of such calls.

In case preference shares are to be redeemed out of profits, an amount equivalent to the nominal value of the preference shares against which calls are in arrears should be allowed to remain in the profit and loss account or the revenue reserve account. On redemption of these shares, such amount should be transferred to Capital Redemption Reserve Account.

Alternatively, the amount may be transferred to Preference Shares Redemption Suspense Account. On redemption of these shares the amount may be transferred to Capital Redemption Reserve Account. Any premium payable on redemption of preference shares may also be put to Preference Shares Redemption Suspense Account. On redemption of preference shares, such account will be debited with the amount of premium paid.

(*ii*) **Sale of Assets.** In case certain assets are sold for raising the necessary liquid resources, selling of such assets will not in any way affect transferring of the amount to the capital redemption reserve account or issue of new shares for redemption as per the requirements of law. Any profit or loss on sale of such assets (unless it is a capital profit) should preferably be transferred to the profit and loss account.

(*iii*) **Unpaid Amount.** In case certain Redeemable Preference shareholders could not be paid the amount due to them due to change of their addresses or their being untraceable, the amount due to them should be allowed to remain in the "Redeemable Preference Shareholders Account or Preference Shares Redemption Account." In the Balance Sheet the amount due to them can be shown under the heading Current Liabilities and Provisions.

The process of making necessary accounting entries, in case of redemption of preference shares can be very well understood with the help of the illustrations given below.

Illustration 14.9. Pioneer Construction Co. Ltd. decided to redeem their preference shares as on31st March, 2017 on which date the position was as under.

Pioneer Construction Ltd.
Balance Sheet as at 31 March, 2017

	Particulars	*As at 31 March, 2017*
		₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	(a) Share Capital	
	Issued Subscribed & Paid up Capital:	
	4,000 Equity shares of ₹100 each	4,00,000
	4,000 Redeemable preference shares of ₹50 each, ₹25 Paid up	1,00,000
	2,000 Redeemable preference shares of ₹ 100 each Fully paid	2,00,000

NOTES

	Particulars	*As at 31 March, 2017*
		₹
	(*b*) Reserves and Surplus	
	Securities Premium Account	10,000
	Capital Redemption Reserve	90,000
	Dividend Equalisation Reserve	1,10,000
	(*c*) money Received Against Share Warrants	–
		9,10,000
2.	Share Application Money Pending Allotment	–
3.	Non-current Liabilities	–
4.	Current Liabilities	–
	(a) Short-term Borrowings	–
	(*b*) Trade Payables	90,000
		90,000
	Total (1) + (2) + (3) + (4)	10,00,000
B	**Assets**	
1.	Non-current Assets	–
2.	Current Assets	
	(*a*) Current Anvestments	–
	(*b*) Inventories	–
	(*c*) Trade Receivables	–
	(*d*) Cash and Cash Equivalents	1,40,000
	(*e*) Short-term loans and Advances	–
	(*a*) Other Current Assets	8,60,000
	Total (1) + (2)	10,00,000

The redemption was to be at a premium of 5 per cent. The Capital Redemption Reserve appearing in the balance sheet is the reserve brought into being as a result of a redemption which took place in 2000. To enable the redemption to be carried out the company decides to issue, after carrying out the necessary formalities required under law, sufficient number of new equity shares at a discount of 10 per cent. The redemption is duly carried out. Show journal entries relating to the redemption and new issue and also the balance sheet after redemption. Ignore the question of dividend upto the date of redemption.

Solution:

Tutorial Notes:

(*i*) Amount to be paid to preference shareholders:

As Share capital	₹ 2,00,000
As Premium on redemption	10,000
	2,10,000

Please note that only preference shares fully called and paid up are to be redeemed. No redemption can be carried out of 4,000 redeemable preference shares which are partly called and paid up.

(*ii*) Arrangement for redemption:

(*a*) ₹ 10,000 premium on redemption can be provided out of Securities Premium Account already appearing in the Balance Sheet (*See entry No. 5*).

(*b*) Preference Capital of ₹ 2,00,000 has to be redeemed. The number of new shares to be issued has not been given. However, in the absence of any specific amount in the question, their number has to be minimum. A sum of ₹ 1,10,000 is lying in the Dividend Equalisation Reserve. Redemption can be carried out of profits to this extent. The amount has therefore been transferred to Capital Redemption Reserve (*See entry No. 2*).

The balance has been redeemed by issuing new shares. Since the new shares are being issued at a discount, the number of new shares required to be issued to collect the necessary proceeds would amount to 90,000/9 = 10,000 (*See entry No. 3*).

Pioneer Construction Co. Ltd
Journal

S. No.	*Particulars*		*Dr.* ₹	*Cr.* ₹
(1)	Preference Share Capital A/c(fully paid)	*Dr.*	2,00,000	
	Premium on redemption of pref. shares A/c	*Dr.*	10,000	
	To Sundry preference shareholders A/c			2,10,000
	(Being amount due to preference shareholders on redemption, including premium at 5%)			
(2)	Dividend Equalisation Reserve	*Dr.*	1,10,000	
	To Capital redemption reserve A/c			1,10,000
	(Being transfer to the latter account as required by law, to the extent the redemption has been from distributable profits)			
(3)	Bank A/c	*Dr.*	90,000	
	Discount on Issue of Share A/c	*Dr.*	10,000	
	To Equity share capital A/c			
	(Being issue of new equity shares @ 10 per cent discount for the purpose of redemption of preference shares to the extent required)			1,00,000
(4)	Sundry preference Shareholders A/c	*Dr.*	2,10,000	
	To Bank			2,10,000
	(Being payment made to preference shareholders)			
(5)	Securities Premium A/c	*Dr.*	10,000	
	To Premium on redemption of preference shares			10,000
	(Being writing off premium on redemption of preference shares from share premium)			

Pioneer Construction Ltd.
Balance Sheet as at 31 March, 2017
(*Summarised balance sheet after redemption***)**

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	(*a*) Share Capital	
	Issued Capital: 5,000 Equity Shares of ₹ 100 each	5,00,000
	4,000 Redeemable Preference Shares of ₹50 each, ₹25 Paid up	1,00,000
	(*b*) Reserves and Surplus	
	Capital Redemption Reserve	2,00,000
	Discount on Issue of Shares	(10,000)
	(*c*) money Received against Share Warrants	

NOTES

	Particulars	₹
		7,90,000
2	Share Application Money Pending Allotment	–
3.	Non-current Liabilities	–
4.	Current Liabilities	–
	(*a*) Short-term Borrowings	–
	(*b*) Trade Payables	90,000
		90,000
	Total (1) + (2) + (3) + (4)	8,80,000
B	**Assets**	
1.	Non-current Assets	–
2.	Current Assets	
	(*a*) Current Investments	–
	(*b*) Inventories	–
	(*c*) Trade Receivables	–
	(*d*) Cash and Cash Equivalents	20,000
	(*e*) Short-term Loans and Advances	–
	(*f*) Other Current Assets	8,60,000
	Total (1) + (2)	8,80,000

Use of Mathematical Equation

Sometimes the use of a mathematical equation becomes necessary to find out the number of new shares to be issued. This particularly happens when a minimum new issue is to be made at premium or discount, the preference shares are to be redeemed at premium and the existing amount of divisible profits and share premium are not sufficient to redeem the preference shares in full.

The algebraic equation taking the new issue as *x* can be put as follows:

Red. Pref. Share Capital + Premium on Redemption	=	Premium in Balance Sheet	+	Divisible Profits in Balance Sheet	+	*x i.e.*, New Issue	+	Premium on *x* (or less Discount)

Illustration 14.10. Prosperous Ltd. has 12% preference share capital of ₹ 1 lac consisting of₹ 100 shares fully called and paid up. The company wants to redeem them at 10% premium. The ledger accounts show the following balances:

Profits & loss A/c	₹ 20,000
Securities premium	4,000

The directors desire to make a minimum fresh issue of equity shares of ₹ 10 each at 5% premium for redemption of the preference shares.

You are required to ascertain the amount of such fresh issue to be made by the directors and pass the requisite journal entries.

Solution:

Since, the new issue of equity shares is to be made at a premium of an amount which is the minimum for redeeming preference shares, a mathematical equation will have to be used.

Let the new issue be of ₹ x

Redeemable Preference Share Capital + Premium on redemption	=	Share Premium as given + *P*. & *L*. A/c balance + Proceeds of fresh issue + Premium on fresh issue.

$$= 1,00,000 + 10,000 = 4,000 + 20,000 + x + x/20$$

or $1,10,000 = 24,000 + 21x/20$

or $-21x/20 = -1,10,000 + 24,000$

or $-21x/20 = -86,000$

or $21x = 86,000 \times 20 = 17,20,000$

$x = 17,20,000/21$

or $= 81,905$

Thus, a minimum new issue of ₹ 81,905 will have to be made for redemption of preference shares.

Verification In case each share is of ₹ 10, face value, 8,191 shares will be issued. The amount realised would be as under:

Share Capital	8,191 × 10	= ₹	81,910.00
Share Premium	8,191 × 0.50		4,095.50
			86,005.50
Total amount required for redemption:			
Red. Preference share capital			1,00,000
Premium on Redemption			10,000
			1,10,000
Amount Available for redemption:			
Share Premium (4,000 + 4,095.50)		= ₹	8,095.50
Profit & Loss A/c balance			20,000.00
Proceeds from new Issue			81,910.00
			1,10,005.50

Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Redeemable Preference Share Capital A/c	*Dr.*	1,00,000	
	Premium on Redemption of Pref. Shares	*Dr.*	10,000	
	To Redeemable pref. shareholders A/c			1,10,000
	(Being amount due to preference shareholders including 10% premium)			
	P&L A/c	*Dr.*	1,904.50	
	Share premium A/c	*Dr.*	8,095.50	
	To Premium on redemption of pref. shares			10,000
	(Being providing for premium on redemption)			
	P&L A/c	*Dr.*	18,095.50	
	To Capital redemptional reserve			18,095.50

NOTES

Date	Particulars	Dr. ₹	Cr. ₹
	(Being transfer of balance in P. & L. A/c to Capital redemption reserve to provide for redemption of preference shares)		
	Bank A/c Dr.	86,005.50	
	To Equity share capital A/c		81,910.00
	To Securities Premium A/c		4,095.50
	(Being issue of 8,191 shares of ₹ 10 each at 10% premium)		
	Redeemable pref. shareholders A/c Dr.	1,10,000	
	To Bank A/c		1,10,000
	(Being money paid to preference shareholders on redemption)		

Check Your Progress

3. What is the intention of the law to keep Capital Redemption Reserve Account's use only for issuing fully paid bonus shares?
4. Where is the unpaid amount due to Redeemable Preference shareholders shown in the Balance Sheet?

14.4 RIGHT ISSUE

Meaning In case of joint stock companies or corporations, generally the shareholders are given the pre-emptive right either by their Charter or by the Act applicable to them. This pre-emptive right gives holders of common stock (or equity shares) the first option to purchase additional issues of common stock.[2]

A pre-emptive right (popularly termed simply as "right") may therefore be defined as an option to buy a security at a specified price during a specified period. "Right shares" are the shares so issued to the shareholders under such pre-emptive right.

Purpose Issue of right shares serves two purposes:

(*i*) It preserves the power of control of the present shareholders. In the absence of such a right, the existing shareholders may be deprived of their controlling power if a large number of shares are offered for subscription to outsiders.

(*ii*) It prevents loss to the existing shareholders on account of dilution of the value of their shareholdings. For example, a company has a share capital of 1,000 equity shares of ₹ 100 each but having a market value of ₹ 150. The company needs additional funds of ₹ 50,000. It offers to outsiders 500 equity shares at ₹ 100 each. In such a case the total market value of the firm after the new issue would be ₹ 2,00,000 (*i.e.*, 1,50,000 + 50,000) and the value per share would come down to ₹ 133 (*i.e.,* 2,00,000/1,500) each. Thus, offering new equity shares

[2] Section 62 of the Companies Act, 2013 also gives this pre-emptive right to shareholders in India.

below market value will dilute the value of the equity shares. It will be detrimental to the present equity shareholders but beneficial to those who have purchased the new shares.

Valuation of rights When a company offers new shares to the existing shareholders, they are generally offered at a much lower price than their market price. This is because of two reasons. First, the company wants to give the existing shareholders some advantage because of their continued association with the company. Secondly, the company wants to make the right issue a success and therefore it takes into account the possible fall in the market value of the company's shares on account of a right issue.

On a right issue being made, the existing shareholders have the privilege of either applying for the shares offered within a fixed period (usually 30 days) or to renounce their right to apply for these shares in favour of some other person. Since the right issue is being offered at a concessional price, an existing shareholder can make a profit by selling his right to apply for the new shares. He may sell this right with or without selling his existing shareholding. The price of the shares may therefore be either *cum-right price* or an *ex-right price*. The *cum-right price* gives the buyer, besides the ownership of the shares already held, the right to apply for new shares offered by the company, while the *ex-right price* gives the buyer only the ownership of the existing shares held by the seller and not the right to apply for additional shares offered by the company. *Ex-right price* is quoted either after the right shares have already been allotted by the company or the time to apply for right shares has already expired.

The *cum-right price* is higher than the *ex-right price* of the shares since the former includes the value of the right also. The value of the right can be calculated by applying the following formula:

$$R = \frac{M - S}{N + 1}$$

where, R = Value of one right

M = Cum-right market price of a share

S = Subscription price for a new share

N = Number of old shares required to purchase one new share

Illustration 14.11. *A* Ltd. has a share capital of 5,000 equity shares of ₹ 100 each, having a market value of ₹ 150 per share. The company wants to raise additional funds of ₹ 1,20,000 and offers to the existing shareholders the right to apply for a new share at ₹ 120 for every five shares held. You are required to calculate the value of a right.

Solution:

$$R = \frac{M - S}{N + 1}$$

$$R = \frac{150 - 120}{5 + 1} = \frac{30}{6} = ₹\ 5$$

NOTES

The value of one right is, therefore, ₹ 5.

Valuation of a share ex-right The ex-right value of a share can be determined by deducting the value of right from the cum-right market price of the share. For example, in the illustration given above, the ex-right value of a share would be ₹ 145 (i.e., ₹ 150 – 5). The same result can be obtained by applying the following formula.

$$P = \frac{MN + S}{N + 1}$$

where, P = Theoretical market value of a share ex-right

M = Cum-market price

N = Number of old shares entitling purchase one new share

S = Subscription price for a new share.

On the basis of the data given in the above illustration, the theoretical ex-right value of a share will be as follows:

$$P = \frac{150 \times 5 + 120}{5 + 1} = \frac{750 + 120}{6} = ₹\ 145$$

The value of right by this method also comes to ₹ 5 (*i.e.*, 150 – 145)

14.5 DEBENTURES

Companies require money from time to time. This requirement is met by the company partly by raising share capital and partly by depending on public borrowings. One form of such public borrowings is to raise money by issue of debentures. Debentures help the companies in borrowing money from a large section of the general public. A debenture is of a small denomination (usually of ₹ 100) and, therefore, can be purchased even by persons of small means. For example, if a company needs a sum of ₹ 1,00,000 it can offer to the public for subscription 1,000 debentures of ₹ 100 each. It may be difficult for one person to lend a sum of ₹ 1,00,000 to the company but he can conveniently purchase a certain number of debentures, thus helping the company in raising the required funds.

Meaning of Debentures

Debenture may be defined as a certificate issued by a company under its seal acknowledging debt due by it to its holder. The most essential characteristic of a debenture is the admission or record of indebtedness.

According to the Companies Act, 2013 the term debenture includes "debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not". [Sec. 2(30)]

The term "debenture stock" is similar to "share stock". It is the aggregate and consolidated amount of borrowings on account of debentures by a company. Fully paid debentures can only be converted into debenture stock. Such stock can be divided and transferred in any convenient parts.

A company cannot issue debentures carrying any voting rights [Sec. 71(2)].

Bonds and Debentures

Bonds are a form of long term debt and can be referred as a debt security. Bond may be defined as a debt security in which the issuer (borrower) of the bond owes the holder (lender), a debt and depending on the terms of the bond is obliged to pay interest on the amount borrowed and repay the principal at maturity. In other words, the bond is a formal contract to repay the borrowed money with interest at fixed intervals.

A bond is similar to a debenture. A debenture, as stated before may be defined, a certificate issued by a company acknowledging the debt due by it to its holder. The most essential characteristic of a debenture is the admission or record of indebtedness. Debentures may be both, secured or unsecured.

In some countries, e.g., in U.S.A., a difference is made between a debenture and a bond. The term debenture is used for a debt instrument which is unsecured or which does not have a charge against some specific property of the borrower. Moreover, a bond has a longer maturity, period as compared to a debenture.

In India, no such difference is made between a debenture and a bond. They are used as interchangeable terms. Of course, the term bond is generally used in India for a debt security issued by Government or a Public Institution. Both debentures and bonds are debt securities issued for long term borrowings, i.e., borrowings for more than a year.

Classification of debentures

A company may issue various kinds of debentures with different rights as given below.

From the Point of View of Security

Naked debentures These are debentures which do not carry any charge on the assets of the company. The holders of such debentures are not given any security as to the payment of interest and repayment of capital.

Mortgage or secured debentures Debentures which are secured by a mortgage or charge on the whole or a part of the assets of the company are known as mortgage debentures.

The date of redemption of secured debentures should not exceed ten years from the date of issue except debentures issued for infrastructure

NOTES

projects where secured debentures may be issued for a period exceeding 10 years but not exceeding 30 years.

Sometimes on the same security, money is borrowed by the company by issuing debentures in two or more instalments. Debentures so issued may be given priority in repayment depending upon the order in which they have been issued, Debentures issued earlier will have priority over debentures issued later. Mortgage debentures may, therefore, be further classified as follows:

(i) **First debentures.** These debentures have priority over other debentures as regards payment out of the proceeds of the property mortgaged.

(ii) **Second debentures.** These debentures are repaid after the claims of the first debentures have been met.

For example, a company has freehold property worth ₹ 1,00,000 against which First debentures of ₹ 60,000 and Second debentures of ₹ 40,000 were issued. In case the property is sold for ₹ 90,000, out of the sale proceeds, First debentureholders will be paid ₹ 60,000 and the balance of ₹ 30,000 will be used for payment to Second debentureholders.

Trust Deed In case of mortgage debentures issued to public, it becomes essential for the company to appoint trustees who will hold the property given by way of security in trust for the benefit of all debentureholders. This is necessary because it is impossible to give each debentureholder title deeds of the mortgaged property. The company acknowledges its indebtedness to the trustees and conveys them legal and equitable interest in the property given by way of security for the loan by handing over the relevant title deeds.

From the Point of View of Redemption

Redeemable debentures Redeemable debentures provide for the payment of the principal amount on the expiry of a certain period. Redeemable debentures can be reissued even after they have been redeemed until they have been cancelled. Upon such reissue, the person entitled to the debentures will have the same rights and priorities as if the debentures had never been redeemed.

Irredeemable debentures In the case of irredeemable or perpetual debentures, the company does not give any undertaking of repaying the money borrowed by issuing debentures, after a fixed time or within a fixed period during the continuance of business by the company. Company may repay debentures at any time it may choose to do so, but the creditors cannot compel the company to repay them at certain time. They shall, however, be repaid when the company goes into liquidation or makes a default in the payment of interest.

From the Point of View of Convertibility

Convertible debentures These are debentures which are wholly or partly convertible into shares of the company as per the terms of their issue.

The issue of debentures with an option to convert such debentures into shares wholly or partly, must be approved by a special resolution passed at a general meeting. Of course convertible debentures at discount as it is prohibited.

Non-convertible debentures Debentures not convertible into shares of the company are termed as non-convertible debentures.

From the Point of View of Transferability

Registered debentures Registered debentures are made out in the names of specific persons, who are registered as a debentureholders in the books of the company. The names of the debentureholders are recorded in the company's register of debentureholders. They are transferable in the same way as shares or in accordance with the conditions endorsed on their back.

Bearer debentures Bearer debentures are treated as negotiable instruments and are transferable by delivery alone. The names of the holders of such debentures are not required to be registered in the register of debentureholders.

Accounting for Issue of Debentures

The entries for issue of debentures are made on the same pattern as for issue of shares. They can also be issued at par, premium or discount. However, the legal restrictions regarding use of premium money or issuing at discount applicable in the case of shares, are not applicable to debentures. The accounting entries are being given below:

Issue of debentures for consideration other than cash

(*i*) **On acquisition of assets:**

Assets A/c (with value of assets)	*Dr.*
To Vendors (with purchase price)	

In case the value of assets is more than the purchase price, the balance is credited to Capital Reserve. In a reverse case, *i.e.,* where the purchase price is more than the value of assets purchased, the balance is debited to Goodwill Account.

(*ii*) **On allotment of debentures:**

Vendors	*Dr.*
To Debentures A/c	

In case debentures are issued at a discount, the 'Debenture Discount Account' will be debited with the amount of discount allowed. In case issue of debentures is at premium, the "Debenture Premium Account" will be credited with the amount of premium.

NOTES

Issue of debentures for cash

(*i*) **For receipt of application money:**

Bank A/c	*Dr.*
To Debenture application A/c	

(*ii*) **On allotment of debentures:**

Debenture application A/c	*Dr.*
To Debentures A/c	
(For transfer of debenture application money)	
Debenture allotment A/c	*Dr.*
To Debentures A/c	
(For allotment money due)	
Bank A/c	*Dr.*
To Debenture allotment A/c	
(For receipt of allotment money)	

In case allotment is made at premium and premium is to be received on allotment, the entry for amount due on allotment will be:

Debenture allotment A/c	*Dr.*
To Debentures A/c	
To Debenture premium A/c	

In case allotment is made at discount, the entry will be:

Debenture allotment A/c	*Dr.*
Discount on issue of debentures A/c	*Dr.*
To Debentures A/c	

(*iii*) **On first/second/final call:**

Debentures first/second/final call A/c	*Dr.*
To Debentures A/c	
(For first/second/final call due)	
Bank A/c	*Dr.*
To Debenture first/second/final call A/c	
(For first/second/final call money received)	

(*iv*) **If money is received in one instalment:**

If issued at par:

Bank A/c	*Dr.*
To Debentures A/c	

If issued at discount:

Bank A/c	*Dr.*
Discount on issue of Debentures A/c	*Dr.*
To Debentures A/c	

If issued at premium:

Bank A/c	*Dr.*
To Debentures A/c	
To Debentures Premium A/c	

(*v*) **For payment of interest of debentures:**

Debenture interest A/c	*Dr.*
To Bank	
To Tax deducted at source	

Notes:

(a) It is customary to prefix the rate of interest payable on debentures with the "Debentures Account". For example if the rate of interest payable on debentures is 10%, debentures account will be termed as, "10% Debentures Account".

(*b*) Income tax is to be deducted at source at prescribed rates by the company paying interest on debentures. Tax so deducted is deposited by the company on behalf of debentureholders with the Central

Government. The debentureholder can get credit for the tax deducted on the basis of Tax deduction certificate issued by the company.

Illustration 14.12. In February 2016 A Ltd., offered for subscription 1,000 14% debentures of₹ 1,000 each at the issue price of 94%, payable ₹ 50 per debenture on application, ₹ 500 on allotment and the balance on 1 May, 2016. Interest was payable half yearly on 30 June and 31 December. The first coupon payable on 30 June 2016, being for 5%. The issue was fully taken up.

NOTES

Rate of Tax Deducted at source is 10%. Journalise the transactions and show how they would appear in the Company's Balance Sheet as on 31st Dec. 2016.

Solution:

***A* Ltd.**
Journal

Date	*Particulars*		Dr. ₹	Cr. ₹
2016	Bank A/c	*Dr.*		
Feb.	To 14% Deb. application A/c		50,000	
	(Being application money received on 1,000 debentures @ ₹ 50 each)			50,000
	14% Debenture application A/c	*Dr.*	50,000	
	To 14% Debentures A/c			
	(Being transfer of application money to 14% debentures account on allotment vide Board's Resolution No. ..... dated ......)			50,000
	14% Debenture allotment A/c	*Dr.*	5,00,000	
	Discount on issue of deb. A/c	*Dr.*	60,000	
	To 14% Debentures A/c			5,60,000
	(Being money due on allotment vide Board's Resolution No......dated.....)			
	Bank A/c	*Dr.*	5,00,000	
	To 14% Debenture allotment A/c			5,00,000
	(Receipt of allotment money)			
1 May	14% Debenture first & final call A/c	*Dr.*	3,90,000	
	To 14% Debentures A/c			3,90,000
	(Being first and final call due on 1,000 debentures @ ₹ 390 per debenture)			
	Bank A/c	*Dr.*	3,90,000	
	To 14% Debenture first & final call A/c			3,90,000
	(Being receipt of first and final call money)			
30 June	Debenture interest A/c*	*Dr.*	50,000	
	To Bank			45,000
	To Tax deducted at source			5,000
	(Interest paid on debentures for half year @ 5 per cent on ₹ 10,00,000 after deduction of tax)			

NOTES

Date	Particulars		Dr. ₹	Cr. ₹
31 Dec.	Debenture interest A/c	*Dr.*	70,000	
	To Bank			63,000
	To Tax deducted at source			7,000
	(Payment of debenture interest for half-year ended 31 Dec. 2016)			
31 Dec.	Profit and Loss A/c	*Dr.*	1,20,000	
	To Debenture interest A/c			1,20,000
	(Being transfer of debenture interest to Profit & Loss A/c)			

* The money was received on debentures on different dates. Instead of calculating interest on different amounts received on different dates, the question provides for a flat rate of interest of 5% on the entire amount for the first six months.

***A* Ltd.**
Balance Sheet as on 31st Dec. 2016

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	(*a*) Share Capital	
	Issued & Paid-up Capital _ equity shares of _ each	
	(*b*) Reserves and Surplus	....
	Profit and Loss A/c	(1,20,000)
	Discount on Issue of Debentures	(60,000)
	(*c*) Money Received Against Share Warrants	–
		(1,80,000)
2	Share Application money Pending Allotment	–
3	Non-current Liabilities	
	(*a*) Long-term Borrowings: 14% debentures	10,00,000
	(*b*) Deferred tax Liabilities (net)	
	(*c*) Other Long-term Liabilities	
	(*d*) Long-term Provisions	
		10,00,000
4	Current Liabilities	
	(*a*) Short-term Borrowings	–
	(*b*) Trade Payables	–
	(*c*) Other Current Liabilities	12,000
	(*d*) Short-term Provisions: Tax deducted at source	–
		12,000
	TOTAL (1) + (2) + (3) + (4)	8,32,000
B	**Assets**	
1.	Non-current Assets	–
2.	Current Assets	
	(*a*) Current Investments	–
	(*b*) Inventories	–
	(*c*) Trade Receivables	–
	(*d*) Cash and Cash Equivalents	8,32,000

	Particulars	₹
	(*e*) Short-term Loans and Advances	–
	(*f*) Other Current Assets	–
		8,32,000
	TOTAL (1) + (2)	8,32,000

Note: Separate notes for various items of Balance Sheet have not been made in the absence of detailed information.

NOTES

Check Your Progress

5. Define pre-emptive right.
6. What are naked debentures?

14.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. When a company goes into liquidation within one year of the forfeiture of shares, the ex-shareholder can be put on "List B contributories'.
2. In case, the forfeited shares are reissued at discount, the amount of discount cannot exceed the amount that had been received on these shares.
3. The intention of the law to keep Capital Redemption Reserve Account's use only for issuing fully paid bonus shares is to keep intact even redeemable preference share capital by replacing such share capital by share capital issued for cash or issued out of profits as bonus shares.
4. The unpaid amount due to Redeemable Preference shareholders are shown in the Balance Sheet under the heading Current Liabilities and Provisions.
5. A pre-emptive right (popularly termed simply as 'right') is defined as an option to buy a security at a specified price during a specified period.
6. Naked debentures are debentures which do not carry any charge on the assets of the company.

14.7 SUMMARY

- Forfeiture of shares may be defined as termination of membership and taking away of the shares because of default in payment of allotment and/or call money by a shareholder. The Companies Act does not contain any specific provision regarding forfeiture of shares.

NOTES

- The following points should be taken into account while passing an accounting entry for forfeiture of shares.
  - (i) The amount called up on the shares forfeited.
  - (ii) The amount unpaid on various calls (including allotment) on the shares forfeited.
  - (iii) The amount received on the shares forfeited.
- Forfeited shares become the property of the company and the company can always reissue them at its convenience. They can be reissued at par, premium or discount. However, in case they are reissued at discount, the amount of discount cannot exceed the amount that had been received on these shares. In other words there cannot be any loss on account of reissue of forfeited shares.
- While passing accounting entries regarding reissue of forfeited shares the following points should be taken into account.
  - (i) The amount at which they are taken as paid up on reissue.
  - (ii) The amount that had already been received on the shares forfeited.
  - (iii) The amount allowed as discount.
- In case of joint stock companies or corporations, generally the shareholders are given the pre-emptive right either by their Charter or by the Act applicable to them. This pre-emptive right gives holders of common stock (or equity shares) the first option to purchase additional issues of common stock.
- Pre-emptive right (popularly termed simply as "right") may therefore be defined as an option to buy a security at a specified price during a specified period. "Right shares" are the shares so issued to the shareholders under such pre-emptive right.
- A company cannot return its share capital to its shareholders during its lifetime except as provided under provisions The Companies Act (e.g. buy-back of shares). However, a company can issue a special category of shares termed as Redeemable Preference Shares, which the company can redeem during its lifetime as per the provisions of Section 55 of the Companies Act, 2013. These provisions have been framed keeping in view the fact that the interest of the third parties are not adversely affected on account of return of share capital to the shareholders.
- Debenture may be defined as a certificate issued by a company under its seal acknowledging debt due by it to its holder. The most essential characteristic of a debenture is the admission or record of indebtedness. According to the Companies Act, 2013 the term debenture includes "debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not". [Sec. 2(30)].

- Bonds are a form of long term debt and can be referred as a debt security. Bond may be defined as a debt security in which the issuer (borrower) of the bond owes the holder (lender), a debt and depending on the terms of the bond is obliged to pay interest on the amount borrowed and repay the principal at maturity. In other words, the bond is a formal contract to repay the borrowed money with interest at fixed intervals.
- Debentures are classified from the point of view of security, from the point of view of redemption, from the point of view of convertibility and from the point of view of transferability.

14.8 KEY WORDS

- **Forfeiture of shares:** It is defined as termination of membership and taking away of the shares because of default in payment of allotment and/or call money by a shareholder. The Companies Act does not contain any specific provision regarding forfeiture of shares.
- **Pre-emptive right:** It refers to as an option to buy a security at a specified price during a specified period.
- **Rights shares:** It refers to the shares that are issued to the shareholders under such pre-emptive right.
- **Debentures:** It is defined as a certificate issued by a company under its seal acknowledging debt due by it to its holder.

14.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. List the provisions for forfeiture of shares under the Model Articles of a company limited by shares.
2. Write a short note on calls in arrears in case of redeemable preference shares.
3. What is the purpose of issue of rights shares?
4. What are cum-right price and ex-right price?
5. Briefly explain the concept of bonds and debentures.

Long Answer Questions

1. Explain the accounting entries for various conditions under the forfeiture of shares.
2. Discuss the major provisions related to the redemption of preference shares.

NOTES

3. Mention the accounting entries to be passed in the books of a company which wants to redeem its redeemable preference share capital.
4. Explain the classification of debentures.
5. Mention the accounting entries for issue of debentures in different cases.

Practical Problems

1. *X* Co. Ltd. invited applications for 2,00,000 equity shares of ₹ 10 each on the following terms:

Payable on application on 31 Jan.	2016	–	₹ 5 per share.
Payable on allotment on 28 Feb.	2016	–	₹ 3 per share (including ₹ 1 per share as premium)
Payable on final call on 30 June	2016	–	₹ 3 per share.

   Applications for 2,50,000 shares were received. It was decided:
   (*i*) to refuse allotment to the applicants for 10,000 shares.
   (*ii*) to allot in full to applicants for 40,000 shares.
   (*iii*) to allot the balance of the available shares *pro rata* among other applicants.
   (*iv*) to utilise excess application moneys in part payment of allotment moneys.

   One shareholder to whom shares had been allotted on pro rata basis failed to pay the amount due on allotment and on call and his 200 shares were forfeited. 150 of these shares were reissued on 31 October, 2016 at ₹ 9 per share.

   Give the necessary Journal entries and prepare the Cash Book to record the above transactions.

   [**Ans.** Amount. transferred to Capital Reserve on reissue of forfeited shares ₹ 787.50]

2. Wye Ltd. was formed with an authorised capital of 2,00,000 equity shares of ₹ 10 each on 1 July 2016. 1,00,000 shares were issued as fully paid to the vendors for properties purchased.

   On the same day the company offered 80,000 shares to the public. The issue was fully subscribed. The amount on these shares was payable as follows:

On application	₹ 2.50 per share
On allotment	₹ 2.50 per share
On first call	₹ 2.50 per share (due on 1st September)
On second call	₹ 2.50 per share (due on 1st December)

   On the shares subscribed for by the public, the following had been paid on 30 June, 2017.

On	60,000	shares	the full amount called
On	18,000	shares	₹ 7.50 per share
On	500	shares	₹ 5.00 per share
On	1,500	shares	₹ 2.50 per share

   On 30 June, 2017 the directors forfeited the shares on which less than ₹ 7.50 had been paid. The calls in arrears on 18,000 shares were collected on 31 July, 2017 together with the necessary interest. The forfeited shares were reissued on the same date at a price of ₹ 8 per share.

   You are required to pass the necessary journal and cash book entries and show how the various items will appear in the Company's Balance Sheet as on 31 Dec. 2017.

   [**Ans.** Amount. transferred to Capital Reserve on reissue of forfeited shares ₹ 2,250]

3. Chinubhai Chunilal Ltd. made an issue of 30,000 shares of ₹ 10 each, payable ₹ 3 on application, ₹ 5 on allotment and ₹ 2 on call. 93,200 shares were applied for and owing to this heavy over-subscription allotments were made as under:
   (*a*) Applicants for 21,500 (in respect of applications for 2,000 shares or more) received 10,200 shares.
   (*b*) Applicants for 50,600 (in respect of applications for 1,000 shares or more but less than 2,000) received 12,600 shares.
   (*c*) Applicants for 21,000 (in respect of applications for less than 1,000 shares) received 7,200 shares.

Cash thus received after satisfying amount due on application was applied towards allotment and call moneys and any balance was then returned. All moneys due on allotment and call were received.

Write up the Bank Account and Ledger Accounts relating to this issue in the books of the Company.

[**Ans.** Bank Account Balance Dr ₹ 3,00,000]

4. *X* Co. Limited issued 60,000 equity shares of ₹ 10 each at a premium of ₹ 2.50 per share payable on application. The amount payable on allotment was fixed at ₹ 4 per share and an equivalent sum was due on a call to be made.

   Total applications received were for 1,10,000 shares and after consulting the Stock Exchange, the following scheme of allotment was decided upon.

Category	*A*	*B*	*C*
Grouping of share	1–100	101–500	over 500
No. of applications received	1,200	175	5
No. of shares applied for	70,000	35,000	5,000
No. of shares allotted	42,000	14,000	4,000

   It was decided that the excess amount received on applications would be utilised in payment of allotment money and surplus, if any, would be refunded to the applicants.

   Samuel, who was one of the applicants belonging to category *A* and had applied for 100 shares, defaulted in payment of allotment money. Theodore who belonged to category *C*, and who had been allotted 800 shares failed to pay the call money. Their shares were forfeited, after the respective calls were made and reissued as fully paid up for ₹ 8 and ₹ 6 per share respectively. Pass the necessary journal entries.

   [**Ans.** Amount transferred to Capital Reserve on reissue of forfeited shares ₹ 1,780]

5. Nitin Co. Ltd. decided to make a rights issue in the proportion of one new share of ₹ 200 each at a premium of ₹ 50 each to the shareholders for every three existing shares. The market value of the shares at the time of announcement of rights issue is ₹ 500 each. Calculate the value of rights.

   [**Ans.** ₹ 62.50]

6. Sunita Ltd. offers to its existing shareholders two shares for every seven shares held by them. The right issue price ₹ 140 (including premium of ₹ 40) and the market value of the share at the time of right issue is ₹ 190 per share. Calculate the value of rights. [**Ans.** Value of right-₹ 11.11]

   [**Hint.** Total cost of 9 shares = ₹ 1,610, Values of right = Market Value–Average Price = ₹ 190 – ₹ 178.89 = ₹ 11.11]

7. 15,000, 9% Redeemable preference shares of ₹ 100 each of Global Customer Care Ltd., repayable at a premium of 12% are now due for redemption. The company has accumulated reserves the amount of which is much in excess the sum required for redemption. In addition, there is a large balance lying securities premium account which is available for payment of premium on redemption.

   Show the journal entries in the books of the company to give effect to above. (*CS Inter, Dec. 2003*)

   [**Ans.** Amount transferred to Capital Redemption Reserve ₹ 15,00,000]

8. *X* Ltd. has the following balance sheet as on 31 March 2016.

_X_ Ltd.
Balance Sheet as at 31 March, 2016

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	(*a*) Share Capital	
	Issued & paid up capital: 10.000 equity Shares of ₹ 100 each	10,00,000
	5,000 Preference Shares of ₹ 100 each	5,00,000
	(*b*) Reserves and Surplus	

NOTES

	Particulars	₹
	Capital Reserve	1,00,000
	Securities Premium A/c	1,00,000
	General Reserve A/c	2,00,000
	Profit and Loss Account	1,00,000
		20,00,000
2.	Share application money pending allotment	
3.	Non-current Liabilities	–
4.	Current Liabilities	
	(*a*) Short-term Borrowings	–
	(*b*) Trade Payables	–
	(*c*) Other Current Liabilities	10,00,000
	(*d*) Short-term Provisions:	
		10,00,000
	TOTAL (1) + (2) + (3) + (4)	30,00,000
B	**Assets**	
1.	Non-current Assets	
	(*a*) Fixed Assets	
	Tangible Assets	22,00,000
		22,00,000
2.	Current Assets	
	(*a*) Current Investments	
	(*b*) Inventories	
	(*c*) Trade Receivables	
	(*d*) Cash and Cash Equivalents	–
	(*e*) Short-term loans and Advances	–
	(*f*) Other Current Assets	8,00,000
		8,00,000
	TOTAL (1) + (2)	30,00,000

Preference shares are to be redeemed at 10% premium. Fresh issue of equity shares is to be made to the extent required under the Companies Act for the purpose of this redemption. The shortfall in funds for the purpose of the redemption after utilising the proceeds of the fresh issue are to be met by taking a bank loan. Subsequently the company decides to issue bonus shares in the ratio of one equity share for every four equity shares held. Show journal entries. (*ICWA Foundation, June 2005 adapted*)

[**Ans.** Amount transferred to Capital Redemption Reserve ₹ 3,00,000]

9. Spotlight Limited has issued share capital of 60,000, 8% redeemable cumulative preference shares of ₹ 20 each and 4,00,000 equity shares of ₹ 10 each. The preference shares are redeemable at a premium of 5 per cent on 1st January, 2016.

   As at 31 December, 2015, the company's balance sheet showed the following position:

Spotlight Ltd.
Balance Sheet as at 31st December, 2015

	Particulars	₹
A	**Equity and Liabilities**	
1	Shareholders' funds	
	(a) Share Capital	
	Issued & paid up capital: 60,000,8% redeemable cumulative	
	preference Shares of ₹ 20 each fully paid	12,00,000
	4,00,000 Equity shares of ₹ 10 each fully paid up	40,00,000
	(*b*) Reserves and surplus	
	Profit and loss account	7,00,000
		59,00,000
2	Share application money pending allotment	–
3	Non-current liabilities	–
4	Current liabilities	
	(a) Short-term borrowings	
	(*b*) Trade payables	11,00,000
	(*c*) Other current liabilities	
		11,00,000
	TOTAL (1) + (2) + (3) + (4)	70,00,000
B	**Assets**	
1	Non-current assets	
	Fixed assets	
	Tangible assets:	
	Plant machinery	25,00,000
	Furniture and fixture	9,00,000
		34,00,000
		34,00,000
2	Current Assets	
	(a) Current investments	3,50,000
	(*b*) Inventories	15,00,000
	(*c*) Trade receivables	14,00,000
	(*d*) Cash and cash equivalents	3,50,000
	(*e*) Short-term loans and advances	–
	(*f*) Other current assets	–
		36,00,000
	TOTAL (1) + (2)	70,00,000

In order to facilitate the redemption of preference shares it was decided:

(a) To sell the investments for ₹ 3,00,000.

(*b*) To finance part of the redemption from company funds subject to leaving of balance in Profit and Loss Account of ₹ 2,00,000.

(*c*) To issue sufficient equity shares of ₹ 10 each at a premium of ₹ 2 per share to raise the balance of funds required.

The preference shares were redeemed on due date and equity shares were fully subscribed.

You are required to prepare:

(*i*) Journal entries to record the above transactions.

(*ii*) A Memorandum Balance Sheet as on completion of redemption.

[**Ans.** Fresh Issue of 75,000 shares, Balance Sheet Total ₹ 65,90,000]

10. Suman Ltd. made an issue of 2,000, 14 per cent Debentures of ₹ 100 each at a premium of 10 per cent. The issue was fully subscribed. Money was payable as follows:
    ₹ 10 on application; ₹ 40 on allotment (incl. premium); ₹ 30 on first call; Balance on final call. According to the terms of issue, payment could be made in full on allotment. Interest at a flat rate on any amounts prepaid being allowable at 7 per cent. Such interest was payable by the company on 31 December. The allottees of one half of the debentures took advantage of the pre-payment terms. The others paid on due dates. Journalise the transactions.

NOTES

Debentures

11. A company issues the following debentures:

    (a) 1,000, 14 per cent debentures of ₹ 100 each at par but redeemable at a premium of 5 per cent after 10 years; (*b*) 500, 14 per cent debentures of ₹ 100 each at a premium of 10 per cent payable at par after 5 years; (*c*) 500, 13 per cent debentures of ₹ 100 each at a discount of 10 per cent but payable at a premium of 5 per cent after ten years; (*d*) 300 debentures of ₹ 100 each as collateral security to a creditor who advanced a loan of ₹ 25,000 to the company; (*e*) Issue of ₹ 10,000 debentures at a discount of 10%.

12. Give journal entries for the following:

    (*i*). The company allots 1,000 12% debentures of ₹ 100 each at an issue price of ₹ 96 per debenture redeemable at a premium of ₹ 8 per debenture. (The liability of premium is also to be recorded at the time of issue of debentures).

    (*ii*) 3,000 fully convertible debentures of ₹ 100 each are converted into 20,000 equity shares of ₹ 10 each at a premium of ₹ 5 per share.

14.10 FURTHER READINGS

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

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

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

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